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A BRIEF STUDY OF BALANCE SHEETS

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IT IS CUSTOMARY to begin each new course of study with a brief description of the subject. What is accounting? What are its boundaries, and what are its uses? If possible, the convention should be respected. " . . . every tradition," Nietzsche tells us, "grows ever more venerable—the more remote its origin . . . The reverence due to it increases from generation to generation."

Accounting has been defined as "the act of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof."[1] Accounting is an art—not a science. It has two major functions: to record and classify events and transactions which are, in part at least, of a financial character, and to summarize, analyze, and interpret the records.

A more significant definition would be of inestimable value to students and laymen alike—perhaps to accountants themselves. Unfortunately, it is not possible to reduce a complex subject to simple terms. Accountants use many common words, such as *profit*, *loss*, *income*, *expense*, and *capital*, with a variety of meanings, and with meanings that frequently differ from those of every-day life. Indeed, the differences are sometimes so great that the study of accounting becomes something of a trip through Lewis Carroll's *Looking Glass*:

> "When I use a word," Humpty Dumpty said in a rather scornful tone, "it means just what I choose it to mean—neither more nor less."
>
> "The question is," said Alice, "whether you can make words mean so many different things."

The accountant's attempt to give common words a chosen meaning—neither more nor less—is not always successful, and it is therefore important to take heed of Alice's warning. But accounting is nevertheless an *act*, and its terms, no matter how common, have meaning with reference to accounting operations. "Words," it has been said, " 'mean' nothing by themselves, although the belief that they did . . . was once (almost) universal. It is only when a thinker makes use of them that they stand for anything, or, in one sense, have 'meaning.' "[2]

That all accountants do not make the same use of identical words is only too apparent to the student. "Bad debts" is said by some to be an expense and by others to be a deduction from sales. Cash discounts and freight on sales are the subject of similar differences. These and other disagreements are disconcerting, to say the least. Nevertheless, it should be understood that diversity sometimes proceeds

[1] American Institute of Accountants, Accounting Research Bulletin No. 9, p. 67.

[2] C. K. Ogden and I. A. Richards, *The Meaning of Meaning*, pp. 9–10.

from the nature of accounting and is fundamental to the art.

Accounting has been described as a "tool" of business.[3] Its procedures, classifications, summaries, and interpretations should be designed to be of use to business men, much as a plane or a saw is designed to be of service to a carpenter or builder. But accounting is more than a single "tool"; in fact, it is a whole set of tools. As a carpenter or builder will want one kind of plane or saw for one service and another kind for another service, a businessman will want different kinds of records and summaries for different services. It may be "proper" to exhibit bad debts as a deduction from sales if the businessman requests information concerning enterprise income, and it may also be "proper" to show the same account as an "expense" if the client or employer wishes to study losses in relation to departments or functions of the business.

The nature of accounting—the meaning and significance of many accounting reports—is fashioned by the demands of businessmen. A proprietor may wish to determine his liability for income tax. He will demand records and summaries that will conform to the requirements of statutes and regulations. At the same time he may wish to ascertain that his expectations of an enterprise income were or were not fulfilled. The records, summaries, and interpretations necessary to satisfy the latter demand may or may not correspond with good tax accounting. What is more, the procedures of good managerial accounting frequently depart from the conventions of proprietorship accounting.

Methods and procedures are flexible, and can be bent to a variety of uses. They are not fixed and rigid—a straight and narrow path to an immutable goal. The form and content of accounting statements will vary according to the purposes for which they are prepared, and in relation to considerations of speed, accuracy, and expense. Standardization and rigidity are greatly to be desired, if for no other reason than to facilitate understanding; yet accounting reports are narratives and, like the story-teller, the accountant must frequently adapt his presentation to his audience and adjust the content of his tale to emphasize his point.

Despite its flexibility, accounting has developed conventional methods and customary forms of presentation. The income statements and balance sheets for similar types of enterprise—for all grocery stores, all oil companies, all haberdashery establishments—tend to have the same general appearance, classifications, and contents. Moreover, there are customs and habits by which accountants measure revenue, expense, costs, and income for a particular type of enterprise. This "generally accepted accounting procedure" usually has stood the test of experience, and is therefore known to obtain results that are satisfactory for some purposes. Experience is attractive and useful; nevertheless, customary methods must be used wisely and never at the expense of judgment.

Judgment, rather than custom, must play the major role for a number of reasons. In the first place, business practices change in time, and satisfactory experience for one generation may be outmoded in another. Business practices may vary from place to place, and for this reason, some accounting is acceptable in England, for example, that is not acceptable in the United States. Conventional procedures are designed for the conventional case, and they may be inappropriate in unconventional circumstances. A large number of persons with dissimilar interests—the management, investors, bankers, lawyers,

[3] George O. May, "The Nature of Accounting," *Twenty-five Years of Accounting Responsibility*, v. II, pt. VI, p. 305.

and governments—may be concerned with the accounts of a particular firm. An income statement and a balance sheet that serve one class of persons may not serve another class equally well.

Procedural changes to meet new or different demands from businessmen, or to account for changes in business practice, are not always accompanied by adequate changes in descriptive titles or terminology. Conventional classifications and summaries frequently remain when the methods they once described have been abandoned. As a result, students, laymen, and sometimes accountants come to regard the elements of an accounting statement as a chemist regards the elements gold, silver, or iron. That nothing could be farther from the case is evident from only a cursory examination of balance sheet history.

George O. May believes that "the present standard (balance sheet) forms . . . are the unsatisfactory outcome of a series of compromises between conflicting aims and modes of thought. . . . "[4] Sometimes the conflict arises between those who write and those who read accounting statements; sometimes the conflict results from a lag in accounting convention as it is related to business practice. Those who believe that the present conventional form of the balance sheet is the least satisfactory of all accounting statements are not without a case. Dissatisfied with an unadorned structure, such as that which characterized the old "T" account form, the profession has surrendered to the almost universal desire for an authoritative report. The result has been to perpetuate an accent on the property and capital aspects of accounting when the demands of many businessmen have induced accountants to change their procedures.

Perhaps the "operational" contents of conventional accounting terminology are best illustrated by a brief, yet critical, study of balance sheets. Littleton is of the opinion that the word *asset*, as a technical term, had its origins in seventeenth century French and English bankruptcy proceedings.[5] Every trader in financial difficulty was advised to prepare a statement of "effects and debts" to deliver to his creditors when they assembled to examine his affairs. The French used the phrases *assez d'effets* and *assez de bon e effets* which were rendered in English as "effects (properties) sufficient to pay." Through long usage or in the translation the nouns *effects* and *effets* were abandoned in favor of the anglicized word *asset* (for the French adjective *assez*). In modern language, an *asset* becomes property available for the payment of debts.

But, as Littleton noted, accounting was not restricted to bankruptcy proceedings and in time the language, if not the words, changed under the impact of greatly altered demands. Management and business owners had occasion to use financial summaries for a variety of purposes including a report of and an accounting for all the business property. The "solvency statement" prepared for creditors would not satisfy the enlarged demands. New accounting procedures were inaugurated; the word *asset* was extended until it covered nearly all the business property; the ingredients of summary reports were changed even though many descriptive titles remained the same.

Possibly the change in the meaning of the word *asset* was gradual, almost imperceptible at the time, and without uniformity as to geographical location or industry. Furthermore it is not likely that those who kept accounts at first said that an asset is "property available for the payment of debts," and that subsequently,

[4] *Financial Accounting* (New York: The Macmillan Company, 1943), p. 240.

[5] A. C. Littleton, "The Accounting Exchange," Accounting Review, XXI, pp. 340–341.

when proprietors demanded more complete summaries, they decided that the word should refer to "property available for use by the business." A cursory examination of the literature and American corporate reports suggests that the history of the word *asset* has not been a straight line of progress, and that the concept has not been made to encompass an over-expanding universe.

As late as May 31, 1865, the annual report of the Boston and Maine Railroad exhibited in place of the modern balance sheet a "Balance Account, after closing Books." Three classes of debit accounts appeared: Construction Accounts (the cost of road and equipment), Property Accounts (supplies such as wood, oil, iron rails, ties, and coal), and Asset Accounts (cash, notes, bills, prepaid insurance, and sundry receivables). Two classes of credit accounts were brought out in strong relief: the Capital Stock Account and Liabilities. A General Reserve Account (the undivided profits to date) was classified as a liability and used to balance the statement.

The "Balance Account" did not replace the "solvency statement." In the same report, the railroad exhibited a "Statement of Assets available for the payment of Debts," in which "assets" and "liabilities" were shown in sharp contrast. Surprisingly, accounts listed as "property" in the "Balance Account" were described as "all other assets" in the latter statement. Two of the receivables were shown as "assets" in the first statement and as "other assets" in the second one. It appears from the evidence that, in reporting solvency, the officers of the Boston and Maine Railroad believed that the word *asset* referred to all business property except road and equipment. However, the meaning of the word varied with the type of statement and therefore with the purposes for which the accounts were summarized. A limited definition was applied when a formal schedule of all accounts was prepared after closing the books.

A study of earlier railroad reports shows that the Boston and Maine practice was not uniform throughout the industry at the time. For example, the officers ofthe Baltimore and Ohio Railroad Company had different ideas concerning accounting terminology. Their annual report, as of September 30, 1856, contained a "Statement of Liabilities and Assets" with accounts classified in the order suggested by the title. Unlike the Boston and Maine schedule, the "capital stock" account was classified as a liability; while a "profit and loss" account instead of a "reserve" was used to balance the statement. Assets included road and equipment, materials for the road and machinery, cash, notes, bills, uncollected revenue, and sundry receivables. Both railroads included the stock of other companies among their assets.

A comparison of the two reports demonstrates that the word *asset* did not have a common point of reference in American railway accounting during the mid-nineteenth century. But there is a deeper significance to be had from the study. Having submitted a "Statement of Liabilities and Assets," the Baltimore and Ohio did not find it necessary to exhibit a "Statement of Assets available for the payment of Debts." Presumably the single, comprehensive summary would do the work of the "balance account" and the "solvency statement" equally well. If not, it must be concluded that the officers of the Baltimore and Ohio believed that those who read the company's annual report would not be interested in the relation between liabilities and the assets available for the payment of debts.

Littleton has shown that "by the end of the nineteenth century the development of separate financial statements was well under way."[6] The "balance account" had

[6] A. C. Littleton, *Accounting Evolution to 1900*, p. 149.

not been discarded altogether: it was merely "old-fashioned." Writing in 1909, Dicksee stated that "Under the Italian system of bookkeeping, which is still practiced in some old-fashioned merchants' houses, it is the custom at every balancing, after the nominal accounts have been closed, to transfer the balances of the real and personal accounts into one account, usually called in England and the United States the 'Balance Account,' and in France the '*Balance de Sortir*,' or 'closing balance'."[7] But in this instance, the author undoubtedly referred to a closing *procedure*.[8] The separate "balance account," raised from the ledger, " . . . would practically be a detailed balance sheet, with the assets upon the Dr. and the liabilities upon the Cr. side, as shown in all our balance sheets."[9]

In some respects, generally having to do with the kind of balances, the "balance account" was similar to the "balance sheet"; nevertheless, some fundamental differences were appearing—differences that involved more than bookkeeping procedures, statement form, and terminology. Businessmen were asking for an authoritative report that could be used by partners, stockholders, lenders, and others interested in the enterprise capital.[10] Accountants responded with balance sheets. Each statement assumed an integrated importance that was not warranted by the "balance account," and which went beyond that exerted by the "Statement of Liabilities and Assets." The balance sheet would take the place of a "Statement of Assets available for the payment of Debts," and it would exhibit a measure of enterprise solvency.

Charles E. Sprague was one of the staunch supporters of the "new" philosophy. He expressed his belief concerning the balance sheet's importance when, in 1907, he wrote that the statement "may be considered as the groundwork of all accounting, the origin and terminus of every account."[11] He placed the assets in the left-hand register, and insisted that "the rights of others, or the liabilities, differ materially from the rights of proprietors."[12] In fact, the firm conviction that the "two branches" of credit accounts differ greatly and require "distinctiv" treatment gave the balance sheet an integrated importance that, in one respect, satisfied the demands of businessmen for an authoritative statement.

The position of the asset category and the emphasis upon the "distinctiv" treatment of proprietorship were to Sprague, and no doubt others, more than a mere arrangement of accounts. The fact is that Sprague thought of insolvency as the converse or "negativ" of proprietorship. "When the assets exceed the liabilities, the difference is proprietorship, or net wealth," he wrote, and "when the liabilities exceed the assets the difference is negativ wealth or insolvency."[13] Such a balance sheet had a story to tell, and in the telling, all the accounts, after closing, were integrated into a whole that revealed one inescapable conclusion—the enterprise was, as of a particular date, either solvent or insolvent.

However proprietorship accounting, of which Sprague was a principal and early American proponent, gave the balance sheet authority that went beyond that of a solvency statement, and presumably satisfied at least some of the demands of businessmen interested in the enterprise capital. "The whole purpose of the business struggle," Sprague wrote, "is the increase

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[7] Lawrence R. Dicksee, *Auditing*, 2nd American ed., R. H. Montgomery, ed., p. 218.

[8] For early references to this practice, see Littleton, *op. cit.*, p. 130, fn.

[9] Dicksee, *op. cit.*, p. 218.

[10] A. C. Littleton, *op. cit.*, pp. 139–140.

[11] *The Philosophy of Accounts*, p. 26.

[12] *Ibid.*, p. 47.

[13] *Ibid.*, p. 54.

of wealth, that is increase of proprietorship," and he continued by saying that "the all-important purpose of the proprietary accounts is to measure the success or failure in increasing wealth."[14] The balance sheet was not only the "origin and terminus of every account"; it was a "summing up at some particular time of all the elements which constitute the wealth of some person or collection of persons."[15]

It is not surprising, in view of the importance attached to wealth, that nominal accounts should be considered of lower rank, and sometimes neglected. Sprague called them "economic accounts," and thought of them as subordinate to proprietorship or balance sheet accounts because they recorded increases and decreases in wealth.[16] Littleton noted that concepts of "cost and income" were not formed during the early stages of proprietorship accounting.[17] This conclusion, to be expected from Sprague's emphasis on the balance sheet, is borne out when the latter lists the words *loss*, *expense*, *charges*, and *outlay* in one column, and the words *profit*, *gain*, *revenue*, *income*, and *earnings* in another column, only to conclude that "all these synonyms (!) are used in various connections with slightly varying shades of meaning, but their general purport is: DECREASE OF WEALTH for services rendered (in the first instance)—INCREASE OF WEALTH for services given (in the second instance)."[18]

The theory was attractive, and while Sprague's influence upon the profession cannot be measured, it is possibly not incorrect to say that he represented in general, if not in particular, the dominant school of thought in America at the time.[19] But some discord developed among the ranks of accountants, even though the notes did not ring the clarion call for reform. The "philosophy" required acceptance of the idea that all assets are wealth or rights thereto, and what is perhaps more important, that the values exhibited for the several accounts are additive. Dicksee, speaking to Americans from abroad through Montgomery, defined an asset as "an expenditure upon any remunerative object."[20] In this instance, the expenditure rather than wealth was emphasized; the distinction between capital and revenue charges became important; and nominal accounts were free from the bonds of a proprietary feudalism.

A deficient glance at scattered texts, without attempting what may be called a "cursory review of the literature," suggests that seldom, if ever, has there been anything approaching complete agreement between practitioners and authorities. In the first place, many accounts have been exhibited more for convenience than their ability to tell an unvarnished tale. Dicksee warned that "nine out of ten published balance sheets include items under 'Assets' and 'Liabilities' which are certainly *not* either one."[21] But lack of harmony sometimes stems from more deep-seated reasons. All too frequently accounting theory is based upon business practices and thinking of a by-gone day, and accounting statements are designed to accommodate a nonexistent businessman.

How many honest words have suffered corruption since Chaucer's days!

Fifteen years after Dicksee's execration, Couchman found that emphasis upon as-

[14] *Ibid.*, p. 59.
[15] *Ibid.*
[16] *Ibid.*
[17] *Op. cit.*, p. 183.
[18] *Op. cit.*, p. 61.
[19] Littleton believes that "he has greatly influenced the teaching of bookkeeping in this country." See *op. cit.*, p. 188.

[20] See *op. cit.*, p. 216. Many of Sprague's ideas first appeared in a series of articles published during July and August, 1880, in the periodical *The Bookkeeper*. The text, entitled *The Philosophy of Accounts*, appeared in 1907 (New York, The Ronald Press). See A. C. Littleton, *op. cit.*, p. 203, fn. 1. The above references are to the text. Dicksee's first American edition was published in 1905 and the second in 1909. The present writer did not have access to data that would permit the ideas of the two authors to be compared within frameworks of time and the stage of economic development.
[21] *Op. cit.*, pp. 218–219.

sets as "property" would not fully explain what had come to be "generally accepted accounting practice." A disciple of the proprietorship school, he was forced to admit that

at various times in balance-sheets certain items will appear among the assets which do not comply strictly with the definition. . . . An illustration of this might be the organization expense of a corporation. This is not property owned nor legal rights to property, nor does it strictly represent a prepaid service. . . . Nevertheless, it is accepted by accountants as a proper asset, if other treatment of it would result in a violation of any accounting principle.[22]

Couchman was mildly concerned with the fact that organization expense and purchased goodwill did not readily fit his definition of an asset, although the accounts appeared as assets in many commanding statements. It was Canning who became disturbed over the differences in definition and accounting practice. Writing in 1929, he gave evidence of a deep conviction that a study of texts would not bear sufficient fruit to yield a harvest of adequate understanding.

What does the accountant mean by the term "assets"? One who seeks an answer by searching the texts on accounting for formal definitions will first be surprised that many, perhaps most, of the writers offer none at all. Or he may find what purports to be a definition confuses the nature of the thing with the measurement of it. He will not need to search far before he will find that the definitions given are confusingly diverse. If he tests an author's own use of the term, he will, in general, have no difficulty at all in finding things treated as assets that do not satisfy the definition given. Nor will he have difficulty in finding that many things literally within the formal definition fail to appear in the asset accounts and statements. The collecting of an extensive, not to say exhaustive, set of definitions does not repay the scissor-work.[23]

Other accounts have come in for their share of protests. George O. May thought it important, when writing of liabilities, to warn that "once more it is necessary to explain that the accounting and colloquial use of a word are not the same."[24] And the Committee on Terminology of the American Institute of Accountants made inquiry concerning the possibility of preparing a report to consider

designations which might be substituted in the proprietorship section of the balancd sheet and which would make it clear that balances in this section reflect investment rather than value and would emphasize the distinctions between (1) legal capital, (2) capital in excess of legal capital, and (3) undivided profits.[25]

The conventional nomenclature associated with assets is generally that which is also associated with property and with capital instruments. *Accounts receivable* and *notes receivable* are balance sheet terms; the words also refer to legal and equitable rights attending particular business transactions. The words *machinery*, *buildings*, and *land* are used in asset accounting; they may also refer to articles of wealth. The designations are sometimes employed to introduce simple, acceptable accounting procedure, or to draw a satisfactory picture of an actual case; yet it is doubtful that accountants have wholly succeeded in their Humpty Dumpty-like efforts to "make a word do a lot of work like that." Perhaps they, too, should "pay extra."

One may seriously ask in connection with balance sheets: Do accountants actually account for accounts receivable, notes receivable, machinery, buildings, and land? Most assuredly Sprague, Couchman, and other proponents of the "proprietorship theory" would have answered in the affirmative.[26] And speaking with references to procedures of a time and place they possibly would be "right." If anything, a "tool" of business should be utilitarian, and firmly embedded in the extant social

[22] Charles B. Couchman, *The Balance Sheet*, p. 28.
[23] J. B. Canning, *The Economics of Accountancy*, pp. 12–13.
[24] *Op. cit.*, p. 191.
[25] *Accounting Research Bulletin No. 12*, p. 109.
[26] An affirmative answer also may have been received from those favoring what Littleton (*op. cit.*, p. 183 ff.) called "the entity theory in accounting."

and economic institutions. The literature of accounting at the turn of the century suggests that accountants were convinced that they were accounting for the business property and wealth, and the rapid growth of the profession in the United States at that time indicates that the then conventional procedures may have satisfied many, if not all, the businessman's needs.

But business practices did not remain static, and the "tools" of one generation failed to satisfy the demands of another generation. Much accounting that had been useful to the businessmen of a bygone day became outmoded. Complex corporate enterprise came to dominate the American scene, as agriculture and trade gave way to industry and commerce. Cost accounting was one answer to the challenge.[27] However, cost accounting was not enough. There was an urgent need for revisions in general accounting, if the profession was to serve adequately in its new environment.

The impact of industrial America upon accounting is found in the shift of emphasis from the balance sheet to the income account.[28] A society with a growing accumulation of capital owned by corporations, and with governments casting an analytical eye over financial reports while groping for nebulous concepts of "fair return," is not likely to be satisfied by an accounting which emphasizes ownership and debts. Proprietorship theory, which defined "profits" and "losses" as increases to and deductions from "net worth," gave way to an income theory that raised the order of nominal accounts, and which gave particular attention to the flow of "revenues" and "expenses" through time.

No doubt the change, like that in the meaning of the word *asset*, was imperceptible at the time. The first full evidence of the shift is explained in the famous letter of the American Institute's Special Committee on Cooperation with Stock Exchanges, dated September 22, 1932, with George O. May as chairman and with Charles B. Couchman as a member.[29] The Committee declared that to speak of the balance sheet as reflecting the values of assets and liabilities on a particular date seems "to involve a misconception of the nature of the balance sheet." The procedures of general or financial accounting were described in terms of extant business practice.

> From an accounting standpoint, the distinguishing characteristic of business today is the extent to which expenditures are made in one period with the definite purpose and expectation that they shall be the means of producing profits in the future; and how such expenditures shall be dealt with in accounts is the central problem of financial accounting.[30]

The "new" accounting, if the adjective may be applied to an art that is forever being adjusted to accommodate businessmen for changes in business practice, did more than raise the status of the previously "subordinate" nominal accounts. Accountants were no longer accounting "for" property and wealth. The era foreshadowed by Dicksee's emphasis on "an expenditure" came of age. And as if to warn those who find it difficult to read summary reports in terms of accounting operations, the American Institute's Committee on Accounting Procedure wrote: "The result of this emphasis upon the income statement is a tendency to regard the balance-sheet as the connecting link between successive income statements and as the vehicle for the distribution of charges and credits between them."[31]

In sharp contrast to Sprague's "origin and terminus of every account," the balance sheet is now recognized as having existence because the flow of time is arbitrarily terminated. A capital expenditure (an asset account) is expected to produce

[27] *Cf.*, *ibid.*, p. 320 ff.
[28] *Cf.*, George O. May, *op. cit.*, p. 5.
[29] *Ibid.*, pp. 72–80.
[30] *Ibid.*, p. 73.
[31] *Accounting Research Bulletin No. 1*, p. 2.

profits in one or more future periods; a revenue expenditure (an expense account) is expected to produce profits only within the current fiscal period. "If the accounting period were increased from the customary year to a decade," May declared, "most of what is now treated as capital expenditure would become chargeable to income; while if the period were reduced to a day, much of what is now treated as current maintenance would become capital expenditure."[32]

Accounting history has not always found accountants willing to "suit the action to the word, the word to the action. . . ." With some exceptions, particularly in connection with the proprietorship section of the balance sheet, there has been no authoritative move in recent years to change conventional account titles in favor of words with more direct reference to accounting operations, and with fewer references to property and business wealth. Possibly the failure to do so results from the fact that, even as a link between successive income statements, the balance sheet still has significant uses of its own.[33]

Were the full significance of modern income accounting to be revealed, the language, if not the words, of balance-sheet records would be radically altered. *Accounts receivable* would be read as *uncollected revenue*, if the accountant had adopted the conventional principle that holds revenue to be realized when a sale is made. *Accounts payable* would be interpreted by the informed reader to mean *unpaid costs*. But the full force of the latter accounting could not be determined without examining balances in other real and nominal accounts. The reader would look elsewhere to find that the costs had or had not been distributed as expense of some fiscal period.

Accounting for so-called tangible and intangible assets would also take on a meaning that would give the language a momentum that it lacked during the reign of proprietorship theory. The accounts *machinery* and *buildings*, if depreciable, would be read in the light of *undistributed costs*, as the emphasis on wealth faded before a revealing reference to the accounting procedure by which the expenditure is matched with revenues through time. A similar interpretation would be given to accounts displaying the investment in patents, franchises, leaseholds, and other intangibles subject to amortization. *Undistributed revenue*, in contraposition to undistributed costs, would give spirit and coloring to accounts recording advances on sales and prepaid income.

Having existence because accountants arbitrarily divide the flow of time into the past and the future, real accounts nevertheless record more than uncollected revenue, undistributed costs, undistributed revenue, and unpaid costs. The balances of some accounts, either by nature or by convention, do not become a part of the revenue or expense streams. Cash and the principal of notes receivable are examples of the first case; while land serves to illustrate the second case. Legal capital, capital in excess of legal capital as well as undivided profits tell an important part of the balance sheet story; yet, unlike accounts receivable or advances on sales, they do not exhibit another (timeless) aspect of income accounting.

Intangibles not subject to amortization, deferred charges, and other "write-off" balances introduce procedural difficulties. However, the fact that time is not encompassed by contractual or legal boundaries does not alter the essential accounting meaning of the record. If the expenditure displayed in the real account may reasonably be expected to produce future revenues, the balance is an undistributed cost. The fact that inaccuracies may result from

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[32] *The Journal of Accountancy*, Vol. LXIII, p. 335; see also H. A. Finney, *Principles of Accounting (Intermediate)*, 3rd ed., p. 207.

[33] See the Committee on Accounting Procedure's warning, *op. cit.*, p. 2.

the distribution among fiscal periods may not be used to bring charges against any one method or classification. The criticism may be levied against nearly all accounting procedure.

In skeleton form, and following the conventional pattern of double-entry bookkeeping, an interpretative balance sheet might read as follows:

PICKNEY'S MARBLE EMPORIUM
Balance Sheet
as of June 30, 1947

Cash	$10,000	Unpaid costs	$15,000
Uncollected revenue	20,000	Undistributed revenue	2,000
Undistributed costs	30,000	Legal capital	50,000
Undistributable debits	10,000	Undivided profits	3,000
	$70,000		$70,000

One feature of the shift in emphasis is the individuality attached to each balance sheet account. Oneness, encouraged by proprietorship theory, is discarded in favor of a meaning to be imparted by each record or class of records. A balance of cash on hand, an amount of uncollected revenue, an undistributed cost, and undistributable debits do not make an integrated whole. Unpaid costs, undistributed revenue, legal capital, and undivided profits are individually important because each account or class of accounts gives significance to the accounting process. In neither case, having to do with debits, credits, or both debits and credits, do the several kinds of balances fit together like the pieces of a jig-saw puzzle. It is possible that for this reason, among others, the Committee on Accounting Terminology defined a balance sheet as:

> A tabular statement or summary of balances (debit and credit) carried forward after an actual or constructive closing of books of account kept by double-entry methods, according to the rules or principles of accounting. The items reflected in the two sides of the balance sheet are commonly called assets and liabilities, respectively.[34]

[34] *Accounting Research Bulletin No. 9*, pp. 68–69.

Describing the balance sheet as a "tabular statement or summary of balances (debit and credit)" suggests that, in some respects, the history of accounting has completed a cycle, and that summary reports have travelled a road back to the "balance account." But the resemblance, if any, is confined to the more formal aspects of accounting dress. A business community that sired income accounting would not be content with the procedures of an agricultural and mercantile society in which the partnership and proprietorship controlled a major portion of the capital assets. There has been no attempt to return to the "Statement of Assets available for the payment of Debts," nor has the modern balance sheet claimed dominion over the territory formerly ruled by a "Statement of Liabilities and Assets." Modestly, and as a companion to the current definition of the balance sheet as a link between successive income statements, an asset is "anything which is reflected as a debit balance that is or would be properly carried forward upon a closing of the books by double-entry methods."[35] And to keep this procedural interpretation company, a liability is

> A thing represented by a credit balance that is or would be properly carried forward upon a closing of books of account kept by double-entry methods, according to the rules or principles of accounting, provided such credit balance is not in effect a negative balance applicable to an asset.[36]

It may seem to the reactionary, looking backwards, that change from emphasis upon wealth and property to an accent upon a "thing" is a distinction without a difference. However, the careful reader is more than likely to find that such is not the case. The division of time between the past and the future must be based upon presumptive evidence. The "going concern" assumption will do for the enterprise as a whole. But the accountant must

[35] *Ibid.*, p. 70.
[36] *Ibid.*

search for a more specific guide when dealing with each debit and credit balance. Property and wealth may assist him in deciding that a balance should be carried forward from the balance sheet date to the future. This use is a far cry from an accounting "for" rights and appropriated material objects. In the one instance, some part of a past cost may be deferred as an expense of a future period because the property acquired in exchange will probably produce revenue after the closing date; in the other instance, when the account is thought to be a record of property, the whole attention is turned toward the future, and the balance sheet loses the historical nature of income accounting and becomes a statement of expectations. In spite of the use of property as a "thing," perhaps the most telling blow against the idea of a distinction without a difference is struck when the Committee declares that any expenditure which is "properly applicable" to the future is presumptive grounds for carrying the balance forward.[37]

Much of the difference between proprietorship theory and income accounting involves the direction in time toward which the balance sheet points. Mindful of the property aspects formerly associated with assets, many writers have portrayed the statement as a "photograph" of business conditions as of a particular date.[38] But, as the Special Committee on Cooperation with Stock Exchanges has emphasized, this concept suggests that "the purpose of the balance-sheet . . . (is) to reflect the values of the assets and the liabilities on a particular date."[39] Present property can only be a right to *future* services. If assets are "property," as proprietorship theorists insist, accounts receivable exhibit a measure of *future* receipts, and the records of the plant account are measures of *future* services in terms of a money unit. If the balance sheet is a connecting link between successive income statements instead of a "picture of the financial structure," and if assets are "a thing represented by a debit balance (other than a deficit)," accounts receivable show a measure of uncollected revenue for a *past* period of time, and the records of the plant account are measures of *past* costs lagged as expense of a subsequent fiscal period or periods. A similar change in direction may be applied to the interpretation of liabilities.

Shifting sands have also brought an uneasiness concerning conventional balance sheet classifications and summations. May believes that "the . . . classifications of today are too largely based upon conditions and needs that have either ceased to exist or are no longer of importance,"[40] and the Committee on Accounting Terminology has seen fit to remark: "It seems desirable that the committee on accounting procedure consider whether or not there should be either some modification of present practice or a fundamental change in classification" of the current groupings.[41] It may be seriously asked, in view of the direction toward which the balance sheet is now said to point: Is the sum of the "fixed assets" which is derived from undistributed and undistributable costs significant? Is the sum of "current assets" which is derived from a balance of cash on hand, an amount of uncollected revenue, an undistributable debit, and an average cost of merchandise determined by the last-in, first-out method a measure of anything? Do the figures described as "total assets" and "total liabilities" indicate anything more than the fact that, after closing, the books balance? Perhaps much of the confusion that currently surrounds

[37] *Ibid.*

[38] See, for example, D. S. Bolon, *Introduction to Accounting*, p. 7: "The balance sheet is designed to show, in an appropriate manner, the financial condition of a business at a given moment of time. It is a summary, stated in terms of money, of all the property owned, all the debts, and the residual equity of the owners at a given date. It is a picture of the financial structure."

[39] George O. May, *op. cit.*, p. 73.

[40] *Ibid.*, p. 242.

[41] *Accounting Research Bulletin No. 22*, p. 180.

the use of accounting statements would be eliminated if the classifications sharply divided the records according to their accounting employment.

New classifications could, if well conceived, clarify the accounting nature of the balance sheet. At the same time, there is some doubt that new arrangements would erase all existing confusions. In the first place, conventional terminology is part of the current language, and a change, even for the purpose of finding a more direct reference to the procedural nature of real accounts, is very likely to bewilder the business community. However, if this consideration is dismissed in favor of a long-run view or a more widespread use of supplementary schedules, another formidable barrier is at once encountered. Businessmen do look forward as well as to the past, and they frequently request financial information fashioned in the crystal light of reasonable expectations.

Canning came to the point from which alternative courses flow when he said that "an asset can exist *as an asset* only in relation to some person or entity whose asset it is."[42] The Committee on Accounting Terminology recognized the importance of a point of view when it wrote that "a distinction can be made between the internal accounting for an enterprise and the accounting for the corporation which carries on the enterprise."[43] Management may demand an "internal accounting," whereas stockholders, bankers, and others may request an accounting "for the corporation." The accountant may prepare statements that look toward the future or the past in accordance with the demands upon him. Unfortunately, he has not always made the direction of his view clear to all concerned.

Management, in looking after enterprise affairs, will presumably wish to maximize revenues and minimize costs. In doing so, it will necessarily look toward the uncertain future, and appraise the probable consequences of alternative business policies. Accountants may be asked to incorporate the results into the books, and to prepare balance sheets that summarize the work together with income statements that reflect change. "Manifestly," wrote the Committee, "there is no objection to showing estimated present values, . . . for internal administrative purposes."[44] While granting this concession to management, the Committee nevertheless was adamant when it spoke of accounting "for the corporation." It recognized, on the one hand, that cost is not always paramount, and that for some purposes, appraisals may be extremely useful. On the other hand, it insisted, "to the corporation itself, cost is the proper foundation of its accounting."[45]

Apparently income accounting, with its historical statements, has been developed for the use of "outsiders," and for management when it wishes to report to "outsiders." Accounting for property and estimated values has not been entirely discarded. However, qualified accountants, in the United States at least, are seldom qualified appraisers, and while appraisals may be incorporated within the accounts, accountants should do so judiciously and then only for internal administration. As an art, accounting cannot be confined within strict, definitive limits. Its roots are in business practice and in the needs of businessmen. To be utilitarian, it must be somewhat flexible, and subject to change as the methods of business change, and as businessmen require new and different kinds of financial information. No word or combination of words can reveal the meaning of its reports, schedules, or summaries. This must come from the subterranean depths of the underlying procedures.

[42] *Op. cit.*, p. 44.
[43] *Accounting Research Bulletin No. 5*, p. 39.
[44] *Ibid.*
[45] *Ibid.*

THE CPA LAW EXAMINATIONS

F. Lanier Cox

A professional qualifying examination such as a state bar examination for lawyers or the CPA examination for accountants, can have one, or both, of two purposes. The examination can be designed for the purpose of determining those whose basic technical knowledge and ability are adequate to warrant their being qualified as members of their chosen profession and held out by that profession as members; or the examination can be designed arbitrarily to restrict membership. Few, if any, professional examinations are deliberately planned for the latter purpose, but in so far as the form or content of any qualifying examination is such that the results do not give a fair evaluation of the real professional abilities of the candidates, to that extent it is serving no purpose other than to restrict membership.

The CPA examinations have been honest, in good faith, attempts to qualify as Certified Public Accountants only those candidates having a thorough knowledge and grasp of approved concepts, techniques, and procedures of their profession. The great amount of sincere thought and study that have gone into the development and improvement of these examinations is revealed by Henry E. Mendes, Chairman of the Board of Examiners of the American Institute of Accountants, in a paper delivered at the fifty-ninth annual meeting of the Institute.[1] The Board of Examiners is to be commended for its lack of complacency, a fault of many professional examining boards, and for its efforts continually to improve the form of the examination to make it a fairer and more accurate gauge of the candidate's professional ability.

Recognizing that the purpose of the CPA examinations has been to select for membership only those candidates who evidence a superior technical knowledge and ability, and appreciating the efforts and planning to make the examinations increasingly better instruments for achieving that purpose, there is, nevertheless, the question of just how well the form and content of the examination in its present state of development permits the accomplishment of this purpose. This article is limited to a discussion of the law part of the CPA examinations as the writer does not deem himself qualified to evaluate the accounting phases of the examinations.

The law examination as it is now given is difficult. There can be no question of that fact. The accompanying table shows the subjects upon which candidates have been examined during the past ten years.

This analysis reveals that candidates have been expected to have a knowledge of at least twenty different fields of law, and since 1943 have been examined on from ten to twelve different subjects on each examination. In addition, beginning with the November examination of 1941, the practice of dividing the individual questions into different parts was inaugurated and the trend has continued until in the May examination of this year eight of the questions had five or more parts. Thus while each question is limited to a particular field, by using several parts to the question, different phases of the subject are covered. When the broad expanse of the subject matter of such fields as contracts and corporations, and the detailed provisions and requirements of such a subject as negotiable instruments, are considered,

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[1] Henry E. Mendes, "Form and Content of CPA Examinations," *New Developments in Accounting—1946.* The American Institute of Accountants, p. 122.

FIELDS OF LAW COVERED BY CPA EXAMINATIONS
1937–1947

	a	b	c	d	e	f	g	h	i	j	k	l	m	n	o	p	q	
May '47		1	1	1	1		1	1	1	1	1	1		1	1			
Nov. '46	1	1				1	1	1	1		11	1			11	1		
May '46	1	1				1	1	1	1	1	1	1		1	1	1		
Nov. '45		1	1			1	1	1			11	1			1	1	1	y
May '45		1	1	1			1	1	1		1	1		1	1	1	1	
Nov. '44	1	1					11	1	11	1	11	1		1				
May '44		1		1	1	1	1	1	1		1	1		1	1	1		
Nov. '43		1	1				1	1	11	1	1	1	1		1		1	
May '43				1			11	1	1		1	1		1	1	1	1	v
Nov. '42	1		11	1		1	111		1		1		1					x
May '42		1		1	1		11	1		1	1	1		1	1			w
Nov. '41		1					111	11		1	11	1			1	1		
May '41		1				1	11	111		1			1		111			
Nov. '40		1	1				111	11			1			1		1		w x
May '40						1	1111	11	1		11	1				·1		
Nov. '39		1			1		111	11			1	1		1		1		u
May '39	1	1	1		1		11	11			1	1		1	1			
Nov. '38		1		1			111	1	1	1	11	1						z
May '38							111	111	1		11				1	1		z
Nov. '37		1					11	11			111	1		1	1		1	
May '37		1					111	11			11	1		1		1		y
Total	5	17	8	7	5	7	44	31	14	8	30	17	3	12	17	12	5	10
Rank	9	4	7	8	9	8	1	2	5	7	3	4	10	6	4	6	9	—

KEY:
a Administration of Estates and Wills
b Agency
c Bailments
d Bankruptcy
e Banks and Banking
f Carriers
g Contracts
h Corporations
i Federal Taxation
j Insurance
k Negotiable Instruments
l Partnerships
m Patents, Copyrights, and Trademarks
n Real Property
o Sales
p Suretyship
q Trusts

Miscellaneous

u Definitions
v Evidence
w Personal Property—Gifts
x Personal Property—Mortgages
y Social Security
z State Taxation

the task of the CPA candidate is even more impressive. Add only the fields of procedure and constitutional law to the above list and you have the equivalent coverage of most bar examinations. Admittedly, the CPA candidate is not supposed to know these various subjects as thoroughly as a candidate for a state bar examination, but to be able to answer correctly, or even discuss intelligently, the questions presented on any of the recent CPA examinations necessitates an intensive study of at least the ten fields covered by the questions actually answered.

The broad scope of the CPA law examinations raises the question of the specific purpose of this part of the examinations. Does it purport to examine the candidate upon his general knowledge of the law or does it attempt to test his knowledge of those phases of the law with which he will be most frequently involved and affected as an accountant? Mr. Mendes has stated that the law examination "should be related, in so far as possible, to problems that a practicing accountant is likely to meet,"[2] and that "the purpose of the law section of the CPA examinations, as has often been stated, is to test the candidate's ability, not with the aim of his practicing law at any time but to enable him to recognize a legal problem when he sees one."[3] This ability to recognize legal problems is necessary, Mr. Mendes states, "in order that he may judge the validity of transactions as reflected in accounts, and also call to his client's attention, for proper legal advice, situations involving legal questions revealed by examination of accounts which otherwise might escape notice."[4]

If this, then, be the purpose of the law examinations, their content and form should be appraised to determine if the examinations as given are actually testing candidates on this basis or whether they are merely testing general knowledge of the law. Many candidates, both successful and unsuccessful, and many practitioners believe that the examinations have been too broad in scope and, consequently, would have made better tests for lawyers than for accountants. When successful practicing accountants of many years experience express an honest conviction of their inability to pass the law section, something is wrong. Limiting the content of the examinations to a few fields such as contracts, partnerships, corporations, negotiable instruments, and Federal taxation, as advocated by some, is not the answer, for accounting experience and accounting problems know no boundaries and are as broad and as varied as business in all of its myriad forms and ramifications.

Nevertheless, there is a sound basis for criticism of the law examinations. In too many instances the questions ask for a knowledge of phases of the law which have little, or no, direct relationship to situations normally arising in even the most varied of accounting practices. For example, in the examination for May of this year, the candidate was asked in an optional question, to name the usual parts of a deed, to define the granting and the habendum clauses of a deed, to name the five usual covenants, and to distinguish between those that are personal and those that run with the land. It is a little difficult to visualize the situation in which the practicing accountant would be called upon to make these technical legal distinctions. Or is it now the task of the accountant to interpret and pass upon the validity of deeds? The examinations for May of 1939, 1940 and 1947 and the November examination for 1943 each contained a question involving a de facto corporation. The problem makes an interesting legal question but it is a rare occasion for an accountant to find need for a knowledge of

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[2] *Ibid.*, p. 128.
[3] *Ibid.*, p. 129.
[4] *Ibid.*

these legal principles. Certainly, the continued repetition of the question is not justified. In the November 1939 examination, the candidate was required to define slander, libel, equity, and bailment—a Duke's mixture of legal concepts having little relationship to accountancy.

These are by no means all of the questions of this type, but they are probably some of the most striking examples. In each case the question must be asked: Does this question carry out the announced purpose of the examination? The answer appears obvious.

Contrast the following questions with the above examples:

November 1945:
No. 1 (a). What essential information should an accountant expect to find in a certificate of incorporation? Name five items which are of particular importance when making an audit.

November, 1941:
No. 10. A corporation has realized an operating profit and has a balance in its surplus account but because of additions to fixed capital assets it has no cash beyond its requirements for working capital.

(a) Can this corporation legally declare a dividend (not a liquidating one)?
(b) On the assumption that such a dividend can legally be declared, how can payment of it be arranged?

November, 1940:
No. 10. A certified public accountant in making his first audit of the books and accounts of a corporation notes that the assets include a parcel of real property. The secretary of the corporation gives him an abstract of title.

(a) Describe an abstract of title and mention three kinds or types of items that might be found in one.
(b) What use should the accountant make of this abstract?

In each of the above illustrations there is a direct relationship between the legal principle involved and accounting practice. It is the existence of this relationship which should be the limiting factor for the scope and content of the CPA law examinations and not particular fields of law. Under this test the examinations would still have a great breadth and range of coverage but would be a more valid test of a candidate's grasp and understanding of legal principles encountered in accounting practice.

The form of the questions is equally as important as their content in adequately carrying out the purpose of the examinations. In the light of the specific purpose ascribed to the law examinations, two criticisms of the form of the law questions can be made. In the first place, many of the questions are solely a test of the candidate's memory and not of his understanding. This type of question puts a premium on cramming and penalizes one who may have a basic understanding of the principles involved but may not be able to list or enumerate in one-two-three order. Another weakness is that facts and rules crammed into the head for the express purpose of passing a memory type examination are not long retained beyond that event. The writer teaches a law review course for CPA candidates and while eighty-nine per cent of the A and B students who have taken the examination have passed the law part, only fifty per cent of the A and B students who delayed one examination after completing the course were able to make the grade.

The following are a few recent examples of the many questions of the memory type to be found in the examinations:

May, 1947:
No. 2(a) Name the essentials of a negotiable bill or note.
No. 8(a) Name and describe the general provisions of the statute of frauds applied to sales.
No. 10(b) Give at least four of the most important principles generally common to bailments.

May, 1946:
No. 1(a) Name four ways in which a contract may be discharged.

To answer each of these questions requires

a good memory but not, necessarily, a proper understanding of the application of the legal principles. For example, the candidate could glibly list the requirements of negotiability and, yet, not be able to recognize their presence or absence in a particular instrument. Certainly, it is this ability to make practical use of legal knowledge that is important to the accountant.

The second and more fundamental criticism of the form of the law questions relates to what has been said previously in connection with the scope and content of the examination and is that the questions generally have been presented as isolated legal situations, and that even where the principle involved is of importance to accountants, little effort has been made to present the problem in the type of fact situation in which the accountant would normally encounter it. The result is that there is little association in the mind of the candidate between the rule of law and the accounting situation in which he will find use for his knowledge.

Some questions by the very nature of their subject relate the legal and accounting problems without particular effort being required to accomplish this result. Note the following parts of a corporation law question from the examination for November, 1946:

> No. 3
> (a) (1) Is there any difference between "treasury stock" and "authorized but unissued stock?"
> (2) May such stock be sold by the corporation for less than par value?
> (b) (1) May stockholders, compel by suit, the payment of dividends from net surplus earnings, when the directors in good faith determine to accumulate them?
> (2) Are there any exceptions? Explain.

Where this relationship is not a natural one, there have been very few questions which have even attempted to present a legal problem in a surrounding fact situation with which the accounting candidate could feel some familiarity. The exceptions to this general form have been very few and have decreased in number rather than increased. The examination for May of this year is an example of an entire examination being devoted to this purely legalistic form. In not one of the questions is there any apparent attempt made to associate or correlate legal principles and accounting practice. The first question of that examination will suffice as an example:

> May, 1947:
> No. 1
> (a) What is the effect of fraud upon a contract?
> (b) What choice of remedies has the defrauded party?
> (c) Where a party breaks his contract, what rights has the other party?
> (d) What is an accord and satisfaction?
> (e) A lease under seal contained a clause giving the lessee the option to purchase the leased premises during the term of the lease for the sum of $1,000. The lessee during the term tendered lessor the $1,000 and demanded a deed. The lessor refused the tender and the deed on the ground that the option was unilateral and without consideration. Was he justified in his refusal? Explain.

The following are illustrations of the type of question which the writer believes to be highly desirable if the law section of the CPA examinations is to accomplish the purpose for which it is avowedly given:

> November, 1945:
> No. 12. An accountant, in making a cash audit of the John Jones Company, finds in the cash drawer the three papers described below. Give your opinion as to the classification, the negotiability, and the valuation of each.
> (Three instruments follow)

> May, 1942:
> No. 6. A certified public accountant in his own office explained to a sales agent representing a manufacturer of calculating machines the kind of work for which the accountant required a machine and stated to the agent that he was relying on the agent's skill and judgment in

recommending a machine for that purpose. The agent thereupon sold a machine for cash to the accountant and gave him a bill of sale which contained no warranty but merely described the machine by style, lot number, and price. If the accountant then discovered that the machine could not do the required work, was there any legal ground upon which the accountant could return the machine and obtain a refund of the purchase price?

May, 1941:
No. 1. A certified public accountant, in his examination of a wholly owned subsidiary corporation, finds that its board of directors has declared a dividend in excess of the amount of surplus at the beginning of the year plus the net profit for the year, and that this dividend has been paid to the parent corporation. What should the accountant do with respect to this situation?

Another excellent example is question No. 10 from the November examination of 1940, set out above in the discussion on the scope of the examination.

This entire evaluation of the CPA law examinations has been made on the basis of the statement of purpose made by Mr. Mendes, and from this analysis the conclusion must be drawn that the examinations fail fairly and properly to effectuate this purpose. If the purpose is valid, the examination should be changed.

There may be many who feel that the examination should not only "be related, in so far as possible, to problems that a practicing accountant is likely to meet,"[5] but that, in addition, it should test the candidate upon a general knowledge of commercial law. It may well be that a compromise could be reached by having the five required questions of each examination relate to legal principles of particular interest to accountants and the optional part of the examination present general questions on the law of business. The writer, however, believes that the present expressed purpose is unquestionably sound, and that each question in every examination should be carefully designed to test the candidate's ability to recognize and handle, as an accountant, the legal problems with which practicing accountants are confronted.

Until this is done, the CPA candidate is faced with the task of having at his finger tips in one-two-three order a multitude of legal rules and exceptions covering some seventeen to twenty fields of law. The last four examinations together have had questions dealing with seventeen different fields. How, then, can the candidate adequately prepare himself?

Candidates who have had formal courses in law at schools having strong commercial law departments have a distinct advantage. And if these courses include as a capstone a special review course for the CPA the task of preparation is simplified but by no means easy. If there is any appreciable time lag between the completion of such courses and the taking of the examination, the immediate utility value of the courses for the purpose of passing the CPA examination decreases rapidly because of the inability of the average human mind to retain a ready recollection of numerous details for more than a comparatively short time. It is necessary, therefore, for all candidates to learn, or review, their law shortly before the examination.

The first step in this process should be a careful reading of some general business law text which adequately covers and presents the course material of the examination. Next, the candidate should acquire or prepare himself, a thorough outline of the material. After a general reading of textbook material, an outline highpoints the more important rules and presents the subject matter in a form which lends itself to rapid review and ready recollection. At this point, it is extremely helpful for the candidate to outline his outline. The making of this short outline tends to condense and digest the material, and when used for

[5] *Ibid.*, p. 128.

last minute review, it acts as a key to the fuller treatment of the basic outline and textbook. A study of prior examination questions and their unofficial answers is helpful in getting oriented to the type and form of questions to be expected.

An examination of the table at the beginning of this article showing a breakdown of the law examinations for the last ten years indicates that certain fields are covered more frequently than others, and that a candidate almost always can count on at least one question from each of the fields of contracts, corporations, negotiable instruments, agency, sales, and federal taxation. For the last eleven examinations, the subjects appearing most frequently in the required section were contracts, corporations, negotiable instruments, agency, and federal taxation in that order. Obviously, it is essential to concentrate upon these fields in the original preparation and in the last review.

Even a painstaking and thorough preparation for the examination does not necessarily guarantee a passing grade. There is always an element of luck as to the specific questions asked, for no matter how careful the preparation has been, a question can well relate to some rule that was overlooked or hurried over because of an opinion as to its relative unimportance. But more important than the element of luck is the ability to answer a law examination. A lack of this ability or know-how is probably the deciding factor with fully a fourth of those who fail.

Most candidates write too much and think too little. The candidate should analyze the question and carefully organize his thoughts before starting to write. The following may prove a helpful outline to use in answering any question based on a fact situation:

Read and analyze the facts.
State the problem of law raised by the facts.
Give the answer.
State briefly the reasons to support the answer given.

Despite the difficulty of the law examinations, the number of those given passing grades on this part of the CPA examination has fluctuated from 26.7% to 55.5% since May, 1937. On the May, 1947 examination which has been criticized by this article, 44.7% received passing grades.[6] Certainly, these percentages are fair and are consistent with the Institute's policy of maintaining high standards for professional qualification. But the question remains: Does preparation for the CPA law examination also prepare the candidate to recognize and handle actual legal problems which he will encounter in his practice, and is the form and content of the examination such that the grade received by a candidate represents a valid evaluation of that ability?

[6] Statistics supplied by the American Institute of Accountants.

THE SEMANTICS OF ANNUAL REPORTS

Don Knowlton

I suppose I might start off this discussion by trying to define the word "semantics." I've gotten into trouble with that word. I wrote a piece a while ago about the "Semantics of Financial Reports," and it fell into the hands of the controller of a large corporation. He wrote me somewhat as follows:

> Dear Mr. Knowlton:
>
> At least six people in our company have told me I ought to study your article on the Semantics of Annual Reports, and I have done so. I started off by trying to find out what the word "semantics" meant. I looked in six dictionaries and couldn't find it in any of them. You say we ought to use terms in our Annual Reports that poeple can understand. Why don't you practice what you preach?

Well, as I understand it, semantics has to do with the connotation of words rather than their actual dictionary meaning. Take the word "capitalist," for instance. Capitalism is defined in my desk dictionary as "the system in which the ownership of land and natural wealth, the production, distribution and exchange of goods, and the operation of the system itself, are effected by private enterprise . . . under competitive conditions."

And yet, what is a "capitalist"? He is a fat man in a long-tailed coat and a plug silk hat, wearing a big gold watch, and bulging with ill-gotten gains derived from the sweat of the working man!

So, in using words for public purposes, one has to think not only of the actual meaning of words, but of their connotation.

Now, there is one word in particular with which we are concerned today. That word is "Profit." It used to command considerable respect. But that was before the days of the New Deal. Today, in many quarters, there is something very reprehensible about profits. A company really ought to feel guilty about making them.

Why is that? Chiefly, I believe, because during the last fourteen years people in general have gotten the idea that business and industry make a great deal more profit than is actually the case. Nobody, people say, would object to a *decent* profit. But it it just isn't right for companies to make such *enormous* profits, especially ". . . since these are made at the expense of the working man and the general public."

According to public opinion polls taken in recent years, many people actually think that corporations make a profit of 25% on sales. They say a profit of 10% would be about right. And many people still identify ownership with management, and think the boss gets all the money. It is interesting that whether polls cover industry in general or a specific industry, whether they cover the general public or employees, the results as to these points are just about the same. In other words, the misconception as to profits, and who gets the profits, is wellnigh universal.

It has been interesting to me to note that when these polls first began to be taken, the individual industry, or the individual company, was inclined to say, "Well, people may think that about the other fellow, but they don't think that way about *our* industry and *our* company"; and then, when polls were taken of this specific industry, or the specific company, the management in that industry, or that company, were flabbergasted to find that they were in exactly the same boat as everybody else.

When the head of a company becomes aware that his own employees, and the public in general, have exaggerated ideas about his own company's profits, and

about who gets the money, his first reaction is one of indignation. As the Financial Vice President of a particular company said to me one day, "Why, they're crazy! Anybody who reads our financial statement would know better than that!"

When I gently tried to remind him that few people can read a financial statement, he just didn't believe me. To him a financial statement was as simple as a 4th grade reader. He assumed that it was equally simple to everybody else. It was his firm conviction that the misconception among the public and among the employees of his company with respect to his company's profits was due solely to the unions, the New Deal, the college professors, the crackpots, and the communists.

I can hardly blame him for his point of view. After all, public-owned corporations publish financial statements in which all of the basic financial facts covering their operations are clearly set forth. These statements are attested to by certified public accountants. They are recognized by the Internal Revenue Department. Shouldn't that be enough? The answer is, of course, that it *isn't* enough. Published financial statements have not done the job which they are presumed to do. Without question they present the facts; but, unfortunately, they present them in such a form that nobody except a banker, an accountant, a controller, a statistician, or what we call a "financial man," can understand them. As far as Joe Doakes is concerned, and for that matter the majority of employees and stockholders and the general public, they might as well be printed in Latin or in Greek. Notice that I include stockholders in the same category with employees and the general public. That's exactly where they belong. The steel industry has about as many stockholders as it has employees. Standard Oil of Ohio has *more* stockholders than it has employees. And most of these stockholders don't understand accounting terminology any more than do the employees.

And that is only half of the story. What is still worse is the fact that many of the words used in financial reports have connotations which are most unfortunate; they tend to give readers an impression that is absolutely contrary to the facts.

In going into detail on this subject before this group today, I decided that I may as well tell what amounts to a confession story. I am going to tell you what happened to me, some few years ago, not long after I had gone into the public relations business. I was concerned about the extent to which the public in general, and the employees of our clients, were getting false ideas about profits. I went to the president of one of our client companies, and I said to him:

> "The New Deal boys are sounding off about enormous profits of industry. The union men who are putting on an organizing campaign are up on soap boxes spouting about the tremendous profits in your industry and your company. These things aren't true. Don't you think it would be a good idea if you gave your employees the actual facts."
>
> "Yes," he said, "I certainly do. Suppose you go ahead and prepare something for our employee magazine that will explain to our employees how much money our company actually makes. Take our last annual report and present it to the employees in words that they can understand. You go up and see our controller. You can get all the facts you need from him."

Well, I sat down to study the financial statement; and the more I studied it, the worse off I got. I couldn't figure out what in Sam Hill it meant. It started off with a statement of Profit and Loss. That had me stopped right there. To my naive mind, a company either made a profit or it made a loss. How could it make a profit and loss at the same time?

When I looked down at the bottom of the page, I found it had made a net profit. Well, I thought to myself, why doesn't the company call the statement a Profit

Statement? After puzzling over that for a while, I figured out that a company wouldn't want to get out something called a Loss Statement, so, I said to myself, these industrial executives are always hedging. They call it Profit and Loss so they can go either way.

Well—then I started down the list of items, and the first thing I ran into was something called "Cost of Sales." This was an enormous amount of money. I never knew it cost the company more money to sell its goods than to manufacture its products; but there it was, in black and white—"Cost of Sales."

By that time I knew I was in way over my head, so I went up to talk to the controller of the company.

"What do you mean by 'Cost of Sales'?" I asked him.

"Oh," he said, "that is what it costs us to manufacture what we sell."

"Well," I said, "why the deuce don't you say so?"

He shook his head severely.

"It isn't done that way," he explained. "*This* is the way it is done."

Then I asked him about depreciation. He explained to me what depreciation meant.

"Oh!" I said, "that means you set aside that much money, out of your year's income, for that purpose?"

"No," he said, "we don't actually set aside the money."

"But," I said, "it says so, right here in your statement, that your depreciation amounts to so much. You subtract it. If you don't set it aside, what do you do with it?"

"Well," he said, "that depends. It isn't actually money and it isn't really set aside. Of course, some people pay it out in dividends, and then they go broke. Other people hoard it up and never use it to buy new equipment, and they go broke, too."

By that time I was about 100 miles under water. I said:

"Do you mean, then, that this figure is just an amount put down on paper?"

"Oh," he said, "I wouldn't go so far as to say exactly that."

"Well," I said, "if you don't actually set aside the money, why do you deduct the amount?'

"My God," he said, "that is tax-free income!"

Well, I will pass over some other items such as "Bond Discount," "Tax Refund Claim," etc.—by that time I was completely dizzy. I might as well just have met the man from Mars. So we finally got to the phrase, "Operating Profit."

I said to the controller, "Here is one item that is called 'Operating Profit,' and here is another item, down below it, that is called 'Net Profit.' That's confusing. If you told me that a company made an operating profit of a million dollars, it would mean profit to me. If you told me a company made a net profit of a million dollars, it would *still* mean profit to me. You have two different profit figures here in your statement."

So, of course, he explained to me what the difference was.

I said, "Why do you call the first one profit when it isn't a profit at all?"

"Oh well," he said, "that is the way it is done." When I asked him why, he acted as if I had assailed the Constitution of the United States, or questioned the law of gravity.

So finally we got down to the net profit figure. I said to him:

"Well, at least I can understand this figure. This is the amount of money that the company actually made. That is what the stockholders really get."

"Oh no," he said, "the stockholders don't get all that money—they get only a part of it."

"Do you mean to say," I asked him, "that the stockholders don't get *all* of the profit that a company makes?"

"Certainly not," he said. "Part of it is paid out in dividends, and the rest goes into the surplus account."

"Surplus account?" I echoed rather faintly. The fact is that I had taken a quick look at the balance sheet and had been *completely* discouraged; and hadn't even turned over the page beyond the balance sheet to find the surplus account.

So this very patient controller explained to me, in words of one syllable, that part of the earnings of the company were paid out in dividends, and that part of them were reinvested in the company; which in technical terminology was known as "Added to Earned Surplus."

At that point I thought I had enough for one day, and I went back down to my office and began to look in the dictionary

again. The first word I looked up was the word "profit."

My dictionary defined "profit" as "the excess of returns over expenditure in a given transaction or a series of transactions." Now, to my simple mind, the excess of returns over expenditure is something that is realized in cash. I buy a jackknife for a dollar and I sell it to a sucker for $1.25. My profit is 25 cents, and it is in the form of a coin in my pocket, along with some old nails and a few pieces of string.

But the controller had just been explaining to me that about half of his company's profit for the previous year had actually been spent for new plants, new machinery, and new equipment; so how could the profit figure, as reported, represent an "excess of returns over expenditure"?

I went back to him and asked him this question.

"You just don't understand," he said. "That's the way it is." And that was when, to my amazement, I discovered that Uncle Sam doesn't regard money spent out of earnings, for long-term investments, as expenditures.

"But aren't expenditures like that necessary?" I asked the controller. "Doesn't a company have to plow back a lot of its earnings into improvements?"

"Of course it does," answered the controller.

"Well," I said, "in that case, regardless of how the Internal Revenue Department looks at it, why in the Sam Hill do you report all of your profit as 'profit'? Why don't you tell how much of the money you earned was paid out in dividends, and how much was reinvested in the business?"

"Oh," he said, "you'll find all that in the surplus account."

There was that confounded word "Surplus" again. He'd told me once before to look at that page—and this time I really looked at it. I found that it was made up of Capital Surplus and Earned Surplus. I didn't know what either one of those terms meant, so I looked up the word "Surplus" in the dictionary, and this is what I found:

Surplus: that which remains when use or need is satisfied; excess; overplus.

That was when I realized why it was that the union agitators and the New Deal could really go to town.

This company had a surplus, if I remember correctly, of some seven million dollars. That, according to the definition of the word, was what remained after use or need had been satisfied. It was excess or overplus. In that case it must be in cash. Oh boy! With that much money in the bank over and above what the company needed, why the Sam Hill shouldn't it grant the wage increase demanded by the union, and grant it tomorrow morning?

Well, then I went on to the balance sheet; and the more I studied the balance sheet, the less I understood it. In the first place, the very idea of a balance sheet didn't make sense to me. It said that a company's assets were exactly equal to its liabilities.

When you say that a man's liabilities are equal to his assets, you mean that he's broke; he isn't worth a nickel. But you know that isn't true about a company—the company itself says it has a surplus over and above its needs. What's the company trying to do—cover up? Misrepresent? Confuse people, so that they won't know the real facts?

What's more, the balance sheet was full of phrases that might as well be written in Greek, such as "Lower of Cost or Market," "Unconsolidated Subsidiary," "Sinking Fund Requirements," etc.

I asked the controller just how they arrived at all the figures on the balance sheet. The deeper I dug in, the less satisfied I was. I finally asked him this flat question. I said:

"Isn't a balance sheet, after all, merely an accountant's method of trying to present a picture? Aren't the actual dollar amounts, with respect to many of the balance sheet items, merely estimates on the basis of best judgment? Isn't it true that the actual dollars stated do not, as to many items,

represent real dollars at all, but dollar figures are used simply because dollars are the only common denominator for measuring values?"

When forced to the wall, the controller admitted that many of the items on the balance sheet were in fact estimates. I was tempted to ask the controller why, in that case, they didn't use round figures, instead of having every item come out with a certain number of cents. But I had already caused that poor man enough headaches, so I didn't go that far.

I *did* ask him why it was necessary to show a balance sheet that balanced. I told him that, according to my kindergarten ideas, a balance sheet was supposed to show how much a company was worth; and to do this, it would be necessary to subtract the company's liabilities from its assets, and come out with a remainder.

"Oh," he said, "of course it could be done that way; but it isn't done that way. You must remember that financial reports must conform to tradition and practice. There must be a standard method of handling these things, because otherwise there will be no common basis of comparison."

That stopped me cold for a while. But I wasn't content. I asked a lawyer friend of mine who, incidentally, was also the vice president of a very large industrial company, why financial reports always had to be done according to Hoyle. His answer was, "You forget the reason for which the financial report, in its present form, was originated. It was invented by corporation lawyers, back in the '80s, for the purpose of concealing from the stockholders the true state of affairs within the company."

Now, no matter how facetious you may consider that remark, I think you must admit that the financial report, as now constituted, has accomplished exactly that result.

As the years have gone by, stock ownership has spread wider and wider, until today the great majority of stockholders are those who own only a few shares of stock. Certainly, the widow McGuire, who has ten shares, or the foreman who owns twenty, cannot possibly be expected to make head or tail out of the company's annual report as now presented.

But to get back to the problem that I was up against. Remember, I was told by the president of this company, "Take our financial report, talk to the controller, and translate the report into terms that the employees can understand."

I will not bore you today with what actually happened. Needless to say, this led us into an involved and tedious process that has been continuing over a period of years. The same situation has happened with respect to hundreds of corporations all over the country. There have been many and varied attempts at translating the annual report in such a way that the employees and the general public can understand it.

I would like to tell you, however, what eventuated in the case of the particular company which I have been discussing. There was finally worked out a report to employees that tried to tell the facts in terms that they could understand. When the president of the company looked over this report, he said, "I rather suspect that most of our stockholders have never understood our formal report; so let's send the employee report *also* to the stockholders."

The next step you have no doubt already anticipated. The next step is the development of a common report that will go both to employees and stockholders. That is now on the agenda for this corporation with respect to its report for 1947. I might add, incidentally, that on my calendar is the date of August 15, as the date upon which this combination report should first be taken up and discussed—in the hope that by March or April of 1948

there may be a meeting of the minds between the controller's office, the public accountants, public relations counsel, and the president of the company, as to just how the financial record of the company for 1947 will be set forth in this joint report.

Of course, if a company is not bound by past precedent, the problem is fairly simple. Take the case, for instance, of a company which is not publicly owned. Such a company is not compelled to issue any report at all. But nevertheless some companies, not publicly owned, are issuing financial reports to their employees because they consider it good employee relations as well as good public relations.

In this connection I certainly hope that in formal reports some method can be devised whereby the item of Net Profit can be broken down into its component parts: namely, dividends paid out, and money reinvested into the business. This method of reporting makes it possible to show what the company's stockholders actually *took out* in dividends, and to show the portion of the company's earnings that was *reinvested* in the company on behalf of the best interests of both the stockholders and the employees.

But, to my mind, the number one objective in changing financial report terminology should be to get rid of the word "Surplus."

The Standard Oil Company of Ohio has done this job in its 1946 Annual Report. I asked Mr. Hugh Patch, the controller of the Standard Oil Company, to give me an accountant's explanation as to the deviation from standard procedure made in the lower right-hand half of the balance sheet and the table which takes the place of what formerly was the Surplus Account. Here is what Mr. Patch gave me, to read to you today:

It is my belief that forward-looking corporations are coming to the realization that many of the terms used in our formal financial statements submitted heretofore to our stockholders, are unintelligible and meaningless to many of our employees, stockholders, and others who might otherwise be interested in reading our reports. In order to partially overcome this condition we decided to make a start at revision of some of the more commonly misunderstood terms.

Our first step was to change the name of Consolidated Balance Sheet to Consolidated Statement of Financial Position. It is, of course, elementary to controllers and public accountants that the balance sheet is based on the equation of assets equals liabilities plus capital, or stated in another way, assets minus liabilities equals capital or the stockholders' interest. From the standpoint of terms, surveys of public opinion indicate that probably more confusion and misunderstanding has centered around the term "Surplus" and particularly the different kinds of surplus as shown by a balance sheet than any other terms in the financial statements. Accordingly, we felt that this was a good place to start our revision.

I believe even accountants will agree that it is not always clear as to just what is contained in "Paid-In Surplus" and "Earned Surplus," particularly over a period of years, without showing a detailed analysis of these items. It was believed that if these two terms could be eliminated and the different kinds of surplus more properly named as to their content, a step in the right direction would have been made. It was finally decided to give the Capital Surplus the term as shown in our statement, of "Capital In Excess Of Par Value Of Capital Stock Issued." The term "Earned Surplus" was changed to "Net Income Employed In The Business"; analyses being shown, of course, of both of these items.

After further consideration, it was finally decided to show the third element in our equation of capital in a separate statement. This includes the capital stock outstanding and values attached thereto, along with the former surplus accounts in order to state fully and completely our stockholders' interest. It seems to us that the advantage of this presentation is that it shows the detail of our capital stocks represented by their shares and par value and the surpluses applicable thereto in one statement. After giving effect to the shares of common stock held in the Treasury, it then becomes a simple matter to determine the book value of the common stock.

By showing the stockholders' interest on one line in the balance sheet, this completes our balance sheet equation of assets equalling liabilities plus stockholders' interest.

Standard Oil of Ohio is by no means the only large corporation that is trying to work out new financial statement terminology. In fact I have been told by a controller who has been studying this subject that in their 1946 reports at least 70 major companies have done some experimenting along this line.

But if this thing is just going to go haywire, no one is going to get anywhere. As I was told not so long ago, by a CPA whose judgment I greatly respect:

> Terminology in financial accounting must be fixed and universal. It must mean to the accounting profession exactly what Latin terms mean in botany or in medicine. There can be no such thing as accurate reporting unless the terms used are standard terms which mean the same thing to all people. Any other course leads to chaos.

I agree completely with that statement; and I think it is unfortunate that the accounting profession has not taken the lead in changing its own terminology. By failing to do so, it has led large numbers of companies, who have realized the need for new terminology, to "ride off rapidly," as the old story goes, in all directions.

Unless accounting terminology is going to wind up in the madhouse, it would seem to me imperative that public accountants, bankers, controllers, and public relations men get together on the study of this whole problem of the Semantics of Financial Reports, and arrive at a new terminology, more in line with public understanding, which they jointly recommend for universal use.

What we need is a new vocabulary of financial terms. We need words that will mean the same thing to the CPA, the truck driver, the steel-worker, and the controller. We need words that will tell the same story to the auto-worker's wife and the Internal Revenue Department. We need words that no union organizer, no political pleader, no prophet of a new economic panacea, can distort or misuse. That is why semantics is today of such vital consideration in connection with annual reports.

In conclusion, gentlemen, I must emphasize that this problem is in your hands. No lasting progress can be made without your assent and direction. For generations you have thought that your world was one of figures. But mankind does not behave statistically. Mankind reacts to emotions, and emotions are stirred by words, and the right figures will mean nothing if they are tied to words that people misunderstand.

Those of us engaged in trying to tell the facts to employees, stockholders, and the general public, desperately need your help. We are not asking you to forsake the faith of your forefathers. We are asking you to help us spread your gospel. Please, Mr. Accountant and Mr. Controller, can't you figure out words that will mean to everybody what they mean to you?

ACCOUNTING AND THE MANAGEMENT OF PUBLIC AFFAIRS

T. Coleman Andrews

In an excellent article entitled "The Accounting and Treasury Functions in a Modern Organization," Mr. J. A. Campbell, a prominent accountant of Chicago, made the very sage statement that "the accounting department pays its way by serving the business, not by trying to run it." I doubt that anyone could frame in fewer words a more accurate and inclusive statement of the fundamental purpose of accounting than was thus expressed by Mr. Campbell. It will be my purpose in this paper to indicate at least one important way in which accounting can be made to serve business. But before I start let's be sure we all understand what I mean by the word "business."

Most of us, I fear, think of the word "business" as connoting only the activities of private enterprise. Even those of us who think of it as encompassing a wider field often use it in the restricted sense. It is by no means a word of narrow application. Business activity is involved at some point in almost every aspect of human life. Government, for instance—one of the most important aspects of living—is business, the biggest business in the world. The late Franklin D. Roosevelt called it not only the biggest but also the most important business in the world. If government is business—and I agree that it is—there can be no doubt about its relative immensity; and, business or not, the preeminence of its importance can not be denied.

For the benefit of those who require the authority of the lexicon, I cite Funk and Wagnall's Modern Dictionary. It defines the word "business" as embracing, among other things, "commercial affairs," "a matter or affair," and "interest, concern, duty." The creation, management and servicing—to use a word common to public administration—of an aggregate federal, state, and local debt of 272 billion dollars, and the assessing, collecting, and spending of 50 billion dollars in one year, certainly involve engagement in "commercial affairs." This also seems to dispose of the second definition, namely, "a matter or affair." And surely no one will challenge the definition: "interest, concern, duty," for surely nothing is of more interest to all of us, nothing is of greater concern, especially these days, and nothing imposes a higher duty upon any of us than government. And so, let's understand that government as well as private enterprise is business, for it is primarily about the use of accounting in our governmental business that I propose to talk.

On the whole, the administration of public affairs does not require the use of involved accounting systems, procedures, or techniques; except in occasional, special situations, the requirements are simple. But many years ago somebody got the idea that the budgeting of income and expenditures called for special methods and techniques, and somehow or other enough public officials fell for the idea to give it a firm foothold; and enough accountants swallowed it to make CPA problems in "municipal accounting" the reef on which the hopes of many a promising aspirant to an accounting career were wrecked. The whole business of governmental accounting became a confusion of fancy terms: estimated receipts, receipts, revenues, appropriations, authorizations, allotments, allocations, encumbrances, obligations, expenditures, unrealized estimates of receipts, unallocated appropriations, unobligated

allocations, unencumbered allocations, unexpended balances, and so on. Thus governmental accounting became an end unto itself and utterly useless as a managerial device. As a result, accounting became to the average public administrator just a "necessary evil."

In a paper entitled "*Accounting Problems of a Government Agency*," read by Eric L. Kohler at a conference on federal accounting, sponsored by the American Institute of Accountants and held in New York City on December 2 and 3, 1943, the author made this statement:

> From a comparison of governmental operations with those of private business, it is difficult to imagine why government accounting requirements should offer difficulty. Only simple expenditure accounts seem to be necessary, provided, of course, agreement can be reached on the definition of "expenditure." In practice, involved systems of accounting are the rule rather than the exception; not put to active administrative use, they are frequently badly designed and in arrears. Causes are numerous, the principal one being that accounting needs have been met with concepts that have tended to make accounting an end in itself, rather than a means of information and control useful alike to agency management, supervisory financial agencies, and the Congress.

Mr. Kohler spoke from intimate knowledge of the deficiencies of governmental accounting. He had already put in many years trying to bring order out of some horrible examples of what governmental accounting isn't. He had seen his efforts rewarded in the Tennessee Valley Authority where he proved the validity of his criticisms by demonstrating that accounting could be made simple in a governmental agency and still be made to satisfy every budgetary requirement. He also had made it popular with, and indispensable to, the management of the Authority. His method was simple. He merely used the principles and techniques of plain, everyday accounting. For instance, in the classification and distribution of expenditures, he applied the principles of cost accounting; he provided for the recording of expenditures in such a way that the end result was to show the cost of every activity of the Authority. He made the ascertainment of activity costs the primary aim of the system. Objective classification of expenditures was given secondary, if not incidental, importance. Contrast this with the usual practice of putting primary emphasis upon objective classification and the usefulness of the activity approach is at once apparent.

The activities of the Tennessee Valley Authority are somewhat unusual, however; hence, they are not typical of governmental departments and agencies generally. So I will not undertake to explain the Authority's system in detail. Instead, let's apply the principle used there to a familiar set up and see how it would work.

First of all, let us remember what a business organization does and what it is in such an organization that costs money. A business organization establishes and carries on such activities as are necessary to the accomplishment of the purpose or purposes for which it was created. The *activities* that it carries on *are what cost money*.

Then let us remember what an organization's accounting system is supposed to do. It is supposed to be useful to management. If it is to be useful to management, it must present the facts of the business in a manner consistent with management's way of looking at the business. And how does management look at the business? It looks at it as a group of activities which, properly co-ordinated and managed, will accomplish the over-all objective of the business. It looks upon expenses as what they are and nothing more: as the cost of goods and services acquired for the carrying on of the activities of the business. Whether one kind of goods or services, or some other kind, is used by an activity

isn't important of itself. What is important is whether the kind used was needed, whether it was the most appropriate kind to the need and whether its cost was right. The fact that two or more activities use the same kind of goods or services and that the total cost was so much, is of little value to management.

To illustrate, in a business with two or more departments and several activities, a reliable judgment of whether the total cost of telephone services is in line cannot be formed until it is determined that each department's portion is in line; and no judgment as to any department's portion can be formed until it is determined that each activity's portion is in line; hence, if expense accounting is to be useful to management, its primary objective must be the accumulation and disclosure of activity costs, and the kinds of things and services a business buys are of importance mainly at the activity level, where the need for them, their appropriateness and their cost can be adjudged and the benefits derived from the use of them can be appraised.

Now let's go a step further and see how this would work in practice. For the purpose of this demonstration, let's use some ground that will be a bit more familiar to most of us than a department of government. Let's use the accounting department of a private enterprise. The usual activities of such a department are: auditing of income and receipts, auditing of expenses and disbursements, inventory accounting and control, payroll accounting and control, the keeping of vendors' accounts, the keeping of customers' accounts, the keeping of the general books, internal auditing, and so on.

In most businesses the practice as to the classification of expenses is not even to ascertain the expenses of the accounting department as such, let alone the cost of the several activities that constitute the department. The controller's salary probably will be included with those of other executives in both the books of account and the financial statements. The salaries of the employees of the department generally probably will be included in a catch-all item like "salaries of office employees" along with the salaries of clerks, stenographers and other white-collar employees of other departments. The cost of telephone service probably will be shown as one item for all departments, so also the cost of stationery and other so-called "office expenses." No one in the world would be able to look at the books of account or financial reports and see what the word *office* includes, that is, what departments it includes and what the activities of these departments are. Even the total cost of the accounting department is not indicated, let alone the cost of each of the activities that constitute it. I call this sort of accounting obfuscation. Certainly it is not useful information.

Only by classifying the expenses of an organization, whether it be a private enterprise or a division or other unit of government, so that the structure and activities of the organization and the cost thereof will be revealed, can anyone hope to have an understandable basis for judging the necessity for or reasonableness of the organization's expenses. By such classification it is possible to compare the cost of the fundamental elements of the organization from month to month, quarter to quarter, and year to year, or any other desirable period. Such classification and comparison also will reveal at a glance any changes that are made in the structure and activities of the organization, as well as the trend of the costs of the continuing departments and activities. Thus, the existence of a new department or activity and its cost are immediately disclosed, as is also the discontinuance of a department or activity.

Now I am fully aware of the fact that a large percentage of business organizations —and let's not forget that we are still talking about governmental as well as private business—are too small to warrant a clean-cut separation of every activity, that very often a single person may be found taking part in or even having sole responsibliity for one or more activities. In such cases one must apply the rules of common sense and practicality. I'm not talking about splitting hairs.

To illustrate the application of activity classification and reporting to public affairs I'll lift from my memory and experience an actual though disguised organization. We'll see how it was set up, how its expenditures were being reported, and how they are being reported on the activity basis.

The various jobs that this organization is charged with doing are divided between twelve bureaus. There are twelve operating "divisions," therefore, to use a common term for operating units of an organization. The office of the head of the organization is divided into three sections, one of which takes care of the organization's general administration, or house-keeping, while the other two provide advisory services to the head of the organization. Thus the organization consists of sixteen main sub-organizations: The head man's office, the administrative unit, two service units and twelve operating units; and each of these sub-organizations engages in at least three activities in the process of carrying out its main function.

All that the public ever saw of the cost of this organization—and it spent a lot of the taxpayers' money—was an over-all statement of its expenditures, objectively classified; that is, showing how much was spent for salaries, how much for telephone service, how much for stationery, how much for traveling expenses, and so on. This appeared in the annual budget of the unit of government of which the organization was a part. There was nothing to show the costs of the sub-organizations, let alone the costs of activities.

It was sometimes amusing to see what happened when an inquisitive legislator got hold of the organization's budget requests and started asking questions. Invariably there would be a demand for a breakdown of expenditures by organizational units and activities. It took a lot of digging and no little fancy juggling to answer these questions without disclosing a lot of things the organization didn't want to disclose. The significant thing about this illustration was the point of view of the management—the legislators, members of the board of directors—they wanted to know the costs of activities. But the books hadn't been kept that way. *They weren't responsive to the requirements of management.*

Well, what happened was the usual thing. The legislators finally got tired of being given the run around, and a change was ordered. And so, today the organization's books and financial reports show the cost of the head man's office, the cost of each section thereof, the cost of each operating division, and the cost of each activity of each of these sixteen units of the organization; and this showing is carried over into the organization's budget requests. Hence, when anyone looks at the organization's financial reports or budget, he can see clearly what the structure of the organization is, what activities each organizational unit is engaged in and what the cost of each activity is. Thus, if he is struck by the character or amount of any object of expenditure, he can appraise it in relation to the activity on which it was spent.

Incidentally, this piece of accounting surgery paid a handsome dividend. It led to a tremendous increase in the quality of the work done by this organization and an

over-all reduction of 25 per cent in the costs of doing it. It also led to the official demise of a gentleman who evidently regarded the holding of a position of high public trust as a warrant to make suckers of the people who have to pay the bill. It disclosed the fact that the head man enjoyed the luxury of an expensive chauffeur-driven automobile that served no purpose other than the satisfaction of his vanity and an exaggerated feeling of importance. Soon after this discovery the name on his door was changed. He was able to cover up this extravagance when there was no breakdown of expenses, but not so after activity accounting was adopted. Did someone say that accounting doesn't pay off? Or was it that accounting is just a "necessary evil"?

Finally, I think I should point out that the placing of emphasis upon the cost of activities runs counter to the hopes of those who seek uniformity of accounting and reporting by placing emphasis upon objects of expenditure. However, I do not think this need give anyone concern, because the kind of uniformity that is obtained by putting emphasis upon objects of expenditure was nothing but another commission of the old mistake, so often made, of making accounting an end in itself. The whole idea was doomed to failure from the start because it was a turning of the back upon the fundamental rôle of accounting for a purely self-serving bit of mechanics.

It is utterly fallacious to believe that anyone but the managers, and possibly the owners, of a small business could get any value out of statements of expenditures that show only the total cost of each kind of goods or services purchased, without regard to how the business covered by the statements is organized and in what activities it engages in order to accomplish its purposes. Such understanding certainly can not be expected of legislators, who have little time from their legislative duties to gain first-hand acquaintance with such immense and complicated departments, bureaus, institutions, and other agencies of government as exist today. And, if we can not expect such understanding of our elected representatives, what about us, the poor taxpayers?

The best citizen is one who is interested in his government. The most interested are those who know what is being done with their money. The only way to impart such knowledge is to publish the facts in a manner that clearly discloses the organization of the government—whether it be federal, state or local—the activities in which it is engaged and their costs.

Let's remember that the products of the ingenuity and efforts of the accountant are not devised for the benefit of the profession; they are devised for the benefit of the owners and managers of business, whether it be public or private, and for the man on the street. If we fail to meet their requirements, we fail in our professional mission.

There is no such thing as uniformity in business organization and management or in human understanding. Instead there is *multiformity*. The requirements of multiformity are what we must meet if we are to have any hope of justifying ourselves.

MATHEMATICAL FORMULAE AND THEIR INTERPRETATIONS

PHILIP GALITZER

IN ACTUAL practice, is there such a thing as interpreting mathematical formulae with precision? The writer thinks not. The magnitude and complexities of the problems involved in many given situations give rise to interpretations requiring the aid of the courts. Untold factors must be considered before arriving at a decision. The law governing a stated situation must be determined upon the facts and circumstances of the particular case. That there has been constant and recurring litigation with respect to construction and interpretation of mathematical formulae is best attested by legions of cases officially and unofficially reported. The various cases discussed and set forth below merely touch the fringe in the gamut of mathematical formulae and their interpretations.

COMPUTATIONS SUBJECT TO REVISION OF LAW

In the case of Rogers v. Hill, 289 U. S. 582, 53 S. Ct. 731, 77 L. Ed. 1385, 88 A. L. R. 744, the petitioner, owner of stock in the American Tobacco Co. of New Jersey, among other things alleged that the amounts paid under the by-laws were extremely large and therefore ought to be revised by the Court. Part compensation of President Hill, based upon $2\frac{1}{2}$ per cent of the corporate profits, amounted to \$447,870.30 for 1929, and 842,507.72 for 1930. Part remuneration of Vice-Presidents Neiley and Riggio, based upon $1\frac{1}{2}$ per cent of the corporate profits, amounted to \$115,141.86 for 1929, and \$409,495.25 for 1930. These payments were in addition to cash credits and fixed salaries.

The Court held that the cash payments under the applied percentages implied no actual or constructive fraud. However, with the huge increase in profits and the resultant large remuneration in dollars after application of the prescribed percentages, the Court felt that the situation warranted an investigation, fearing that sums so large as salaries "in substance and effect amount to spoliation or waste of corporate property." Continuing, the Court referred to the dissenting opinion of Judge Swan as indicating the proper rule:

> "If a bonus payment has no relation to the value of services for which it is given, it is in reality a gift in part and the majority stockholders have no power to give away corporate property against the protest of the minority." 60 F. (2d) 109, 113. The facts alleged by plaintiff are sufficient to require that the District Court, upon a consideration of all the relevant facts brought forward by the parties determine whether and to what extent payments to the individual defendants under the by-law constitute misuse and waste of the money of the corporation. (Numerous cases cited.)

The standard of measurement was eloquently expressed in the case of Gallin v. National City Bank of New York, 152 Misc., 679, 703, 273 N. Y. Supp. 87, 114, cited in Mann v. Luke, 68 N. Y. Supp. 2d 313, reading:

> " . . . To come within the rule of reason the compensation must be in proportion to the executive's ability, services and time devoted to the company, difficulties involved, responsibilities assumed, success achieved, amounts under jurisdiction, corporation earnings, profits and prosperity, increase in volume or quality of business or both, and all other relevant facts and circumstances; nor should it be unfair to stockholders in unduly diminishing dividends properly payable. . . . " (Numerous cases cited.)

In an earlier case of Mann v. Luke,—

Misc.—, 44 N. Y. Supp. 2d 202, the Court sustained the sufficiency of a pleading on the theory that

> . . . All directors are liable for moneys paid to themselves or to others as a result of miscomputations, regardless of good faith, or the absence of fraud or negligence . . . (cases cited). In such an action the existence of a resolution providing for the conclusiveness of their acts will not save directors from liability for their wrongs.

SALES COMMISSIONS

In the case of Bayer v. Oxford University Press, 270 App. Div. 586, 61 N. Y. Supp. 2d 209, plaintiff entered into a sales employment agreement with defendant-employer whereby among other things, defendant agreed to pay to plaintiff a salary of $6,000 per year in addition to his traveling expenses, plus a commission "on each year's business of 2 per cent on sales ranging from $140,000 to $180,000 and 5 per cent on all sales in excess of $180,000." Subsequently this arrangement was modified. Defendant refused to pay plaintiff commissions of 5 per cent on sales in excess of $180,000 because the applicable prior orders were filled by defendant after the modified arrangement had been in effect. In a unanimous decision, the Court explained the situation in the following language:

> The difficulty with the defendant's position is that the commission constituted a part of plaintiff's compensation for services. The plaintiff had fully performed all the work he was required to do in obtaining the orders which were accepted by the defendant. He did not lose his right to the money he earned because the defendant did not or could not fill all the orders during the year 1942. Had plaintiff left the employ of the defendant at the end of the year 1942, he still would have been entitled to commissions on the 1943 orders subsequently filled. (McCloskey v. Cumberland Glass Mfg. Co., 193 App. Div., 856, aff'd. 233 N. Y. 552; Dibble v. Dimick, 143 N. Y. 549). The fact that plaintiff continued in defendant's employ under a new arrangement did not serve to deprive him of his right to be fully compensated for the services rendered in 1942. . . . He was therefore entitled to receive commission on all 1942 orders when and if filled and the trial court should have awarded him the claimed commissions of $2,369.32.

It is to be noted that the defendant's technical interpretation was sustained in the lower court, but was unanimously reversed in the upper court.

REASONABLENESS OF EMPLOYEE'S COMPENSATION

In James F. Patton v. Commissioner,— T. C.—, CCH Dec. 15, 780 (M), Docket Nos. 10275, 10276, entered April 30, 1947, an employee, K . . . , entered into a written contract with the employers whereby he was to receive a minimum salary of $2,400 per year until such time as $22\frac{1}{2}$ per cent of the net profits of the partnership exceeded $2,400. A provision of the contract entitled employee, K . . . , to receive 10 per cent of the net sales of the company, provided, that commission plus the aforementioned salary did not exceed the stated $22\frac{1}{2}$ per cent of the company's net profits. The employee was paid the sum of $37,949.20 in 1942 and the sum of $46,049.41 in 1943. Although he did not comprehend double-entry bookkeeping, and he did not know the difference between recording on a cash basis and recording on an accrual basis, yet he attended to the accounting records. In addition, his duties consisted of operating a typewriter, conversing with an insurance agent and attending to other minor details. His earnings for some 22 years prior to 1941 did not warrant his filing income tax returns.

Bearing in mind the above, the Commissioner allowed only $13,000 as a reasonable deduction for each of the years 1942 and 1943 and the Tax Court sustained what it characterized as a generous allowance, stating that the increase in sales of the company was due to approaching war and that, in its opinion, employee

K . . . was not in the slightest instrumental in procuring the sales.

Whereas the agreement between employer and employee was legally bona fide, yet insofar as the formula for compensation affected taxes, that agreement in the main was disregarded.

VALUATION OF SHARES

An executor as well as the State Tax Commission desired to know the basis per share of certain stock left by decedent. The par value of the particular stock was $100 per share. Based upon the earnings per share during the year in which the decedent passed away, the book value per share of stock issued would have been $135.43, taking into consideration real estate valuation of some $3,700,000. Based upon the adjusted book value as reflected on a financial statement submitted on behalf of the executor after revaluing the real estate at $1,262,500, the book value of the issued stock would have been $77.51 per share. In the latter figure the Court conceded a deduction of 15 per cent of the entire share value because of the minority interest of the decedent. On behalf of the State Tax Commission, its appraiser fixed the value of the stock at $103.60 per share based upon real estate valuation of $1,635,000. At the date of death of decedent her stock had no established market value. The offer of the corporation, after the death of decedent, to purchase the stock at $33.00 per share was declined. An attempted sale of the stock by the executor to a third party was futile. Finally, the stock was sold at public auction at the price of $60.00 per share to the issuing corporation.

The Surrogate, in pithy form, enunciated the law applicable herein, as follows:

> It is well established that in the case of corporate stock the actual market value of the stock is the standard of valuation. (Matter of Chappell, 151 App. Div., 774). Where the stock has no established market value, in determining the tax on such stock, the fair market value of the stock at the time of death is based upon the corporation assets and other elements tending to establish the intrinsic value of the assets which it represents. (Matter of Hoffman, 204 App. Div., 497.) It is likewise well established that isolated sales of closely held stock prior or subsequent to the death of decedent do not establish the market value of such stock for tax purposes. (Matter of Hoffman, supra; Matter of Colt, 125 Misc. 373, aff'd. 215; App. Div., 804; Matter of Jackson, N. Y. L. J., November 6, 1924; Matter of Davidson, N. Y. L. J., November 18, 1924.)
>
> The said sales do not establish the fair value of such stock. The proof fails to establish any open market for such stock. . . . As such shares were not listed or sold in the open market, the only way to arrive at their value was to ascertain the property they represented. (Matter of Jones, 172 N. Y. 575.)
>
> The Court finds that the evidence supports the valuation of the real estate as fixed by the appraiser and that deduction was justified by reason of the circumstances that such stock represented a minority interest. On all the evidence the Court fixes the value of such stock at $97.84 per share. . . .

Matter of Blanche Potter, dec'd., Westchester County Surrogate's Court, New York Law Journal, November 19, 1946.

STATUTORY FORMULA TO FIX RENT IN EXCESS OF EMERGENCY RENTS

In Matter of 76 Crown Street Corporation, New York App. Div. Second Department, New York Law Journal, April 1, 1947, in a proceeding brought by a landlord to fix the rent in excess of emergency rents as provided under the Commercial Rent Law, the Special Term determined the reasonable rent of the premises as being $10,900 per annum which excluded an item of $1,950 for depreciation as well as $500 for management expense.

The Appellate Division in its opinion, held that the Special Term should not

have disallowed the item of management expense and should have excluded "depreciation" as an item of cost of maintenance or operation of the premises.

The Court said:

> The Special Term properly decided in this proceeding that the landlord was not entitled to rent which would include a net return of 6 per cent on the value of the entire property, plus 2 per cent of the principal of the mortgage, and, in addition thereto, an allowance for depreciation of the building on the property. While the figures of 6 per cent and 2 per cent are not made by the statute a precise measure of the return, those figures are presumed to measure a reasonable return including under proper circumstances, an allowance for depreciation (Shack v. Handel, 271 App. Div., 1, 7, 62 N. Y. Supp. 2d 407). In the present case the presumption is not overcome by the evidence, and a reasonable rent may be fixed by the application of the statutory formula. The item involving repairs as part of the cost of operation and maintenance was properly allowed.

Thus, while sound accounting procedure is in favor of deducting an amount for depreciation as a necessary cost of maintenance and operation, the Court, nevertheless interprets a situation wherein it disregards this important accounting principle.

In computing the reasonable rental under the Commercial Emergency Rent Law, In Application of Michel, 185 Misc., 876, 57 N. Y. Supp. 2d 32, it was categorically held that the statute does not permit consideration of "depreciation," but that it did permit the Court to include

> . . . cost of repairs, decorating and maintenance, furnishing of light, heat, steam, hot and cold water, telephone, elevator service, cleaning service, linen service, janitor service, removal of refuse, and any other facility or privilege connected with or furnished by the landlord for the use or occupancy of the commercial space.

Again, on the same subject, in the Matter of 3426 Third Ave. Realty Corp'n., Supreme Court, Special Term, Part I, Bronx County, New York Law Journal, November 14, 1946, quoting Matter of Frankel (Hatters' Oakhide Boxes), 269 App. Div., 531, 56 N. Y. Supp. 2d 316, it was said:

> "While the Court is to determine what constitutes a reasonable rent for the commercial space, the amount is to be arrived at by a mathematical computation in accordance with a formula set forth in the Law."
>
> . . . Landlord's expenses for office rent, bookkeeping, accounting and management are disallowed.

There again accountants would take issue as to what ought to be incorporated under the expression "costs of maintenance and operation." Yet, except as restricted by legislative enactments, the Court is the sole judge as to the final interpretation in a particular case.

WAGE OVERTIME FORMULA

In Walling v. Belo Corp., 316 U. S. 624, 634, 62 S. Ct. 1223, 86 L. Ed. 1716, the Supreme Court approved a formula which provided for a guaranteed weekly wage, stating:

> But the guaranty contract in this case carries out the intention of Congress. It specifies a basic hourly rate of pay and not less than time and a half that rate for every hour of overtime work beyond the maximum hours fixed by the Act . . . is the agreement between the parties and it is within the letter and the intention of the law.

As a rule, a wage formula will not be upheld if application thereof will not produce a true hourly rate.

The Appellate Division, New York Supreme Court, Second Department, New York Law Journal, March 25, 1947, in Mabee et al., v. White Plains Publishing Co., Inc. insisted that the formulae in the Wage and Hour Manual, 1944–45, page 188, be complied with. The Court found as follows:

> . . . That the plaintiffs did in fact work more than 44, 42 and 40 hours per week in the respective years 1938, 1939.

... That plaintiffs' regular work week was variable in number of hours, and consisted of the number of hours actually worked per week, not 40 hours. Their overtime compensation should be computed on the basis of a regular hourly rate determined by dividing the weekly salary by the number of hours worked in any particular week (Overnight Motor Trans. Co. v. Missel, 316 U. S. 572).

and required that tabulations be presented showing the exact number of overtime hours per week each plaintiff worked during the periods claimed, the rate of overtime applicable to such hours, or the products in dollars and cents of such hours and rates in conformity with the formulae stated hereinabove.

In this instance, the Court was a stickler for mathematical data.

"ACTUAL COST" INTERPRETED

In Zora Realty Co. v. Metropole Food Corp., 268 App. Div., 493, 51 N. Y. Supp. 2nd 826; aff'd. 294 N. Y. 742, 61 N. E. 2d 524, an action was brought under a written lease, assigned to the defendant which assumed all the conditions, terms and covenants thereof. Under one of the paragraphs of the lease the tenant agreed to pay the landlord 20 per cent of all profit procured from the sale of its business and the assignment of the lease. The tenant, upon sale of the business, realized a profit of $38,618.21. On an examination before trial, the tenant showed, from its books and records, cost of installation of its fixtures at $61,703.17 and its accumulated reserve for depreciation of the fixtures and equipment at $55,167.94, or a book value of $6,535.23 at the time of sale which brought $45,000.00.

The question at issue was to determine the profit. Was it to be based upon "actual cost" meaning original cost, or on the net depreciated value? Based upon the original cost it is apparent that the tenant made no profit, but on the contrary suffered a loss, thus: Selling Price, $45,000.00; Original Cost, $61,703.17; Loss, $16,703.17. The trial Court held that the word "profit" under sound accounting practices would require applying the amount of the reserve for depreciation against the original cost. Despite this decision, an appeal was taken and the appellate tribunal held that the agreement did not embody the phrase "less depreciation." It therefore held that actual cost as contemplated meant the price paid upon purchase and all attendant charges appertaining thereto and that the lower Court "strained the meaning of the words 'actual cost' " when it considered depreciation, citing Goodwin v. United States, 10 Fed. Cas., 625, 627.

The judgment of the lower Court was unanimously reversed and the complaint dismissed.

How many would ever think of questioning the meaning of "actual cost"? Most would take for granted that fixtures and equipment would be evaluated by the amount of the reserve for depreciation. Yet, in this case a litigant challenges the generally accepted accounting theory with respect to depreciation as well as the deliberation and conclusion of a Court, and lo and behold, prevails upon appeal!

LAWRENCE V. FOX DOCTRINE ENLARGED

And now, because of the desire of an employee to recover compensation from an alleged employer for 30 weeks' unpaid salary at $95.00 per week, or $2,850.00, the famous "Lawrence v. Fox" doctrine has recently been further extended.

One of the landmark cases in jurisprudence is that of Lawrence v. Fox, 20 N. Y. 268. The right of a beneficiary to sue on a contract made for his benefit, under New York law has been limited to four instances involving the following:

1. A pecuniary obligation running from the promisee to the beneficiary;

2. A contract made for the benefit of the wife or child of a party to the contract;
3. A municipality endeavoring to protect its inhabitants by covenants for their benefit; and
4. A request of a party to a contract whereby the promise runs directly to the beneficiary although he does not furnish the consideration.

The rationale underlying this doctrine has been the subject of untold discussion and interpretation with the result that the law has as yet still not been defined in any clear cut manner.

In Stone v. S. Klein On The Square, Inc., City Court, New York County, Trial Term Part VI, New York Law Journal, May 17, 1947, plaintiff-employee was engaged by S. Klein On The Square, Inc., for a period of one year at a weekly salary of $95.00, pursuant to a resolution adopted by that company's board of directors, which resolution was subject to the approval of its stockholders. Plaintiff's brother, Herbert D. Stone, was President, director and substantial stockholder in the Klein corporation. A controlling stockholder of the Klein corporation, the Grayson-Robinson Stores, Inc., under a written contract with the Klein corporation, undertook to approve the resolution in its entirety with respect to the employment of Stone. However, the agreement was not duly approved by the Grayson corporation.

As plaintiff was about to undertake his duties as assistant buyer, he was told by those in charge, that he was not wanted. Nevertheless, he was paid his weekly salary for a period of 22 weeks notwithstanding the fact that he did not appear for work and that he actually rendered no services. He attempted to secure other employment in the interim but was without success. He then brought an action to recover for unpaid salary against the defendants, S. Klein On The Square, Inc. and Grayson-Robinson Stores, Inc., on the ground that the Klein corporation had engaged him by virtue of the resolution of its boards of directors, although the stockholders of that corporation did not specifically approve the resolution.

It is interesting to observe the reasoning of the Court. Klein's stockholders did not approve the directors' resolutions. If, according to the contention of plaintiff, his contract with the Klein corporation were valid, then he has no cause of action for breach thereof on the part of the Grayson corporation. What the Grayson corporation endeavored to do was to "effect a contract between plaintiff and the Klein corporation."

The Court, after granting Klein corporation's motion to dismiss the complaint as against it, permitted the case against the Grayson corporation to go to the jury. The jury rendered a verdict in favor of the plaintiff and against the defendant, Grayson-Robinson Stores, Inc., for the salary due him for the balance of the term, in the sum of $2,850.00.

The only question before the Court was whether or not plaintiff had a cause of action against the Grayson corporation on the theory that he was a third party beneficiary under the doctrine of Lawrence v. Fox. On this issue, the Court referred to the leading case of Seaver v. Ransom, 244 N. Y. 233, which expounded the law and its limitations applicable to Lawrence v. Fox, and after due deliberation continued:

> . . . there is no reason to exclude the plaintiff, who has a blood relationship with one of the promisees. In addition, we have a circumstance not found in the cases, and that is that there was a partial performance of the promise of the third party, which the promisor knew or assented to. Since defendant, Grayson Corporation, was in control of the Klein Corporation, that could not have been done without its consent. There is no reason, in justice, why a promisor, who has partially performed to the third party beneficiary, should not be held, under the doctrine of Lawrence v. Fox, ***even if it be the first time that it is done.***

Motion to set aside the verdict and to dismiss the complaint denied. (Emphasis supplied.)

Thus, there now is enlargement and extension of the scope of Lawrence v. Fox predicated on partial performance and prior consent. Will the courts proceed to spell out an estoppel?

REFEREE ADOPTS FORMULA IMPROPERLY

Now and then even the alter ego of the Court errs.

In Eugene B. Dunkel v. Albee McDonald, Appellate Division, First Department, New York Law Journal, June 11, 1947, which involved a suit to recover damages for failure to obtain employment on painting a theatrical set, because of the alleged misconduct of the defendant, the Court stated in unmistakable language:

> . . . there could be no rational basis for the formula adopted by the referee in assessing the compensatory damages.
>
> Though plaintiff was not obliged to prove its damages to the dollar, to sustain the recovery allowed he was required to supply some reasonable standard of computation. This he did not do with respect to the claim of loss of earnings for the period involved. Award of the sum of $6,500 for compensatory damages was not warranted.
>
> Applying the 20 per cent profit rate to the amount of the low bid of $10,000 plaintiff is entitled to recover compensatory damages of $2,000.

CONCLUSION

Although the use of care and precision in describing mathematical formulae is essential if litigation is to be minimized or avoided, nevertheless even apparently simple formulae are inherently fraught with dangers that may involve expense and adverse rulings. Too often formulae are inartistically drafted and cluttered with barnacles of if's, and's, and but's.

THE TREATMENT OF UNAMORTIZED DISCOUNT AND EXPENSE APPLICABLE TO BONDS REFUNDED BEFORE MATURITY

B. C. LEMKE

THE SUBSTANTIAL fall in interest rates which began in the early 1930s resulted in a widespread exercise by corporations of the option to call bonds before maturity, where such provision had been incorporated in the bond terms. Even though a call premium had to be paid, the resulting saving in interest cost often was sufficient to make bond refunding appear mandatory. Other reasons which might have tipped the scales in situations where the interest saving may not have been significant, were 1) the substantial saving in taxes based on income in a high tax year if a relatively large amount of unamortized bond discount and expense, applicable to the refunded bond, was present, and 2) the opportunity to issue refunding bonds which omitted restrictive covenants found in the old bonds.

The true nature of unamortized bond discount or bond premium and the correct presentation of the bond liability can be inferred from the ordinary compound interest computations used to arrive at the present worth of bonds. The fact should be emphasized that the effective liability of a specific bond issue at an interim date is its present worth computed by using the yield rate determined at the sale of the issue by the corporation. Accountingwise this is stated as par minus unamortized discount or plus unamortized premium.[1] Traditionally, of course, the bond liability is presented at par on the balance sheet under fixed liabilities, and the applicable unamortized bond discount shown under assets.[2] Bond expenses, as distinguished from either bond discount or premium, are placed properly on the asset side of the balance sheet.

If a bond issue is refunded before maturity, the difference between the gross amount that must be paid to the bondholders in order to effect premature retirement, and the effective liability of such bond issue (par minus unamortized discount or plus unamortized premium as of the same date) represents a financial loss. Any unamortized bond expense as well as other expenses which could have been avoided by not refunding before maturity will increase this loss.

In order to review the accounting treatment of the financial loss at refunding, thirty-four refunding operations of thirty industrial corporations and thirty-one refunding operations of thirty corporations in the public-utility field were selected for review.[3] All of the transactions applied to

[1] An excellent treatment of this subject is included in *Advanced Accounting* by W. A. Paton (New York: The Macmillan Company, 1941). Reference should also be made to *An Introduction to Corporate Accounting Standards* (Monograph No. 3 of the American Accounting Association, 1940), as well as to numerous articles appearing in various publications particularly the ACCOUNTING REVIEW and the *Journal of Accountancy*.

[2] The annual report of Eversharp, Inc. for the fiscal year ended February 28, 1946, shows unamortized premium added to par in the fixed liability section of the balance sheet. No comparable treatment of unamortized discount in an annual report was found.

[3] *Industrial Corporations:*
American Tobacco Company
Armour and Company
Bethlehem Steel Corporation (2)
Celanese Corporation of America
Dow Chemical Company
B. F. Goodrich Company
Hiram Walker-Gooderham & Worts, Ltd.

situations where bonds were called before maturity and replaced by bonds of a larger, smaller, or identical issue during the decade ending with 1945. No attempt was made to include all refunding operations during the decade for each company selected.

The treatment of unamortized discount and expense and call premium applicable to the thirty-four industrial bond issues which were refunded before maturity is summarized as follows:

TABLE I

Disposition of Certain Items Relating to Bonds Refunded Before Maturity by Industrial Corporations Included in the Review

	Unamortized Discount and Expense		*Call Premium*	
	No.	*%*	*No.*	*%*
Prematurely written off	6	18	—	—
Written off to—				
Earned surplus	14		18	
Capital surplus	1		1	
Income	11		12	
	26	76	31	91
Deferred—				
Over original life of the old issue	2		2	
Over life of new issue	—		1	
	2	6	3	9
Total	34	100	34	100

Holly Sugar Corporation
Interlake Iron Corporation
Jones & Laughlin Steel Corporation
Koppers Company
Libby, McNeil & Libby (2)
National Dairy Products Corporation (2)
National Gypsum Company
National Steel Corporation
Remington Rand Inc.
Revere Copper and Brass Inc.
Scovill Manufacturing Company
Simmons Company
Skelly Oil Company (2)
Socony-Vacuum Oil Company
Swift and Company
Texas Corporation
Union Oil of California
United States Rubber Company
United States Steel Corporation
West Virginia Pulp and Paper Company
Wheeling Steel Corporation

The comparable information for the thirty-one issues in the public-utility field is:

TABLE II

Disposition of Certain Items Relating to Bonds Refunded Before Maturity by Public-Utility Corporations Included in the Review

	Unamortized Discount and Expense		*Call Premium*	
	No.	*%*	*No.*	*%*
Prematurely written off	1	3	—	—
Written off to—				
Earned surplus	10		10	
Capital surplus	—		—	
Income	1		1	
	11	35	11	35
Deferred—				
Over original life of the old issue	4		4	
Over life of new issue	6		7	
Over stated number of years	9		9	
	19	62	20	65
Total	31	100	31	100

Wilson & Co., Inc.
Youngstown Sheet and Tube Company

Public Utility Corporations:

American Gas and Electric Company
Appalachian Electric Power Company
Boston Edison Company
Central Illinois Electric and Gas Company
Central New York Power Corporation
Cincinnati Gas & Electric Company
Cleveland Electric Illuminating Company
Commonwealth Edison Company
Consolidated Edison Company of New York, Inc.
Detroit Edison Company
Georgia Power Company
Monongahela Power Company
Montana Power Company
New York Power and Light Corporation
Northern Indiana Public Service Company (2)
Northern Natural Gas Company
Northern States Power Company (Minnesota)
Northern States Power Company (Wisconsin)
Ohio Edison Company
Oklahoma Natural Gas Company
Pacific Gas and Electric Company
Pennsylvania Water & Power Company
Philadelphia Company
Philadelphia Electric Company
Puget Sound Power & Light Company
Southern California Edison Company, Ltd.
Texas Power & Light Company
Toledo Edison Company
Wisconsin Power & Light Company
Wisconsin Public Service Corporation

A comparison of the amount of unamortized discount and expense with the earned surplus at near the refunding date for the industrial corporations revealed a percentage relationship of from 0.4% to 20.6% with an average of 2.2%; in only three cases did it exceed 10%. A comparison with total assets, as of the same dates, showed a range of from less than 0.1% to 2.1% with an average of 0.3%, with only four cases at or above 1%. It will be noted from Table I that the industrial corporations included in the review tended to write off the unamortized discount and expense as well as the call premium at the time of refunding. In several instances the bond discount and expense was written off at the time the bonds were issued or shortly thereafter. In only two cases among the thirty-four were the unamortized discount and expense amounts deferred over a period extending beyond the refunding date. It is noteworthy that in these two instances the unamortized discount and expense also bulked largest in the two percentage comparisons made with earned surplus and total assets in the industrial group.

In the public-utility field the percentage relationship between unamortized discount and expense and earned surplus at near the refunding date ranged from 0.8% to over 600%, with an average of 29.2%, with nine instances over 100%. A comparison with total assets ranged from less than 0.1% to 4.6%, with an average of 1.7%; in twenty-two instances it exceeded 1%. Attention is called to the fact that the comparisons are made with *total* unamortized discount and expense, as revealed in balance sheet data, and not with just the amount applicable to the issue being refunded. Because all older issues of a company would ordinarily be subject to the advantages of refunding sooner or later, it is likely that the treatment of unamortized discount and expense would be determined on an over-all basis rather than on the basis of one issue.

The relationship among several balance sheet items for the companies included in the review is given in the following table.

TABLE III

Summary of Certain Balance Sheet Data for the Corporations Included in the Review

	Industrial Corporations	*Public Utility Corporations*
	(*$000 omitted*)	(*$000 omitted*)
Total assets............	$7,609,358	$7,041,526
Total fixed liabilities....	1,356,770	2,480,904
(% of total assets)....	(17.8)	(35.2)
Total earned surplus....	1,102,909	405,051
(% of total assets)...	(14.5)	(5.8)
Total unamortized discount and expense....	24,093	118,343
(% of total assets)....	(0.3)	(1.7)
(% of earned surplus).	(2.2)	(29.2)

This table reveals the expected; namely, the greater use of bonds in public utility financing and the small surplus balance maintained by public utilities, relatively speaking.

It is considered significant that as a practical matter the industrial corporations could absorb the unamortized discount and expense, if all bonds were refunded, without seriously disturbing the earned surplus balance, whereas this is not true of the public utilities. Based on Table III, almost one-third of the earned surplus of the public utilities would disappear if unamortized discount and expense were written off completely, and a further serious depletion of earned surplus would be brought about by the write-off of the call premium necessary to refund all bonds.

There should be no dispute as to the correct effective liability for any bond issue. The effect then of a deferral of unamortized discount and expense applicable to the *refunded* bond issue is either to understate the effective liability of the *refunding* bond issue, or to admit that the act of refunding can convert a negative

liability into a positive asset, if the deferral is shown as an asset in subsequent balance sheets. To write off instead of to defer these items is a realistic course for an industrial corporation to follow because in no event will future revenue be larger in order to compensate for these items, assuming that, in general, price in the market place is independent of cost in the short run. It does not follow that a public utility faces this same cost-price outlook without modification. Because of the inelasticity of demand for public utility services within the expected price range, it is possible to adjust rates so as to compensate the corporation for any loss or expense within reason. Thus a public utility commission could relieve the stockholders of the necessity of absorbing the cost of refunding by the simple expedient of raising rates or refusing to lower them until such loss has been recovered. What appears to be a compromise method is to defer the unamortized discount and expense together with the call premium and then require that amortization proceed at a rate which will prevent the lowered interest cost from being reflected in the net profit. If such action is taken it is an attempt, in effect, to defer rate action until such time as the financial loss has been absorbed. In four of the nine deferrals "over stated number of years" in Table II the amortization period was determined on this basis. The remaining five of the nine cases represented plans made necessary by special circumstances.

Whether an asset can be created out of a financial loss is an interesting point: as a result of appropriate public-utility commission action a loss can apparently be converted into a call on future revenues or a right to future assets, which in some respects resembles a receivable.[4]

If a public utility commission should allow the deferral of unamortized discount and expense and call premium at refunding, without at the same time making provision for the absorption of such financial loss through increased revenue, it amounts to an admission that a certain minimum dividend rate is justified by circumstances other than the existence of a surplus balance sufficient to cover such disbursement at any particular point in time. It is an admission, in reality, that the customary restriction of dividends to the amount of existing surplus is an unnecessarily harsh one. To give as an alternate reason the preservation of a "good" financial statement is to cast doubt on the intelligence of the investor, if the facts behind the poor surplus or earnings showing are adequately set forth as part of the financial statement.

The refunding operations also had their impact on two interrelated issues not limited to the problem of the correct disposition of the unamortized discount and other expenses resulting from premature refunding operations. One is the proper content of the income statement, and the other is the allocation of income taxes.

There has been a recent tendency to favor the type of income statement which includes gains and losses from all sources with the concurrent result that surplus changes would be restricted to net income and dividends for the most part. In the results of a questionnaire reported on in the *Journal of Accountancy* for July, 1941,[5] Mr. J. C. Clendenin lists only three instances out of forty-one in which the in-

[4] It is assumed that regulation will be close rather than at random. A trend toward a type of regulation which would eliminate the familiar "trading on the equity" was approved in the *Hope Natural Gas Company* case (320 US 605), by implication, in these words, ". . . Rates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed certainly cannot be condemned as invalid, even though they might produce only a meager return on the so-called 'fair-value' rate base."

[5] "How 118 Major Corporations Account for Bond Discount."

come statement was favored over surplus for the write-off of unamortized discount and expense when bonds were refunded before maturity. In Table I eleven instances are listed where the income statement was used by industrial corporations; of these, six occurred after 1941. In the fourteen instances in which earned surplus was used, as shown in the same table, only one took place after 1941. It will be recalled that two issues for each of four industrial corporations were included in the review. Three of these companies used earned surplus for the write-off in 1940 but used income for that purpose in a subsequent refunding operation. The impact of the inclusion of the write-off in the income statement was reduced to a considerable extent by the offsetting saving in taxes based on income, particularly of the excess profits taxes.[6] The American Institute of Accountants stated that " . . . it is sound accounting to show such charges as a deduction in the income statement in the year of refunding in harmony with the treatment required for income tax purposes,"[7] and if these items are charged to surplus or are deferred the total thereof should be reduced by the tax saving. The tax expense in the income statement should be increased a like amount through the expedient of a "charge in lieu of income taxes."

In the public-utility group only one instance is given in Table II where income was charged.[8] In the one case listed as "prematurely written off" the premium from the sale of bonds when offset by the bond expense left a negligible remainder which was written off to surplus. From 1941, on it was common practice to reduce the charge to surplus or the deferral by the amount of tax saving resulting from the refunding transaction. Only two exceptions were encountered in the review after 1940, and in these cases the charge was made to surplus without adjustment.[9] Of the nineteen instances in which the charge to earned surplus or to a deferred account was reduced by the apparent tax saving, the offset in the income statement was listed as an income deduction in thirteen cases, and as an operating expense in nine. The National Association of Railroad and Utility Commissioners and the Securities and Exchange Commission objected to the classification of the tax saving as an operating expense, contending that only the amount which is considered to be payable should be so classified.[10] The Securities and Exchange Commission also objected to the use of "charges in lieu of income taxes" and similar terms and objectives on the grounds that financial accounting is essentially historical in nature and the income statement should show the actual tax provision required without modification. No objection was made to an accelerated amortization of the deferral equal to the apparent tax saving if it was clearly identified as an amortization.

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[6] The unamortized discount and expense and the call premium arising out of the refunding of bonds before maturity had to be taken as a deduction for income tax purposes in the year of refunding regardless of the treatment of these items in the accounts. The U. S. Supreme Court case affirming this opinion of the applicable Treasury Regulation is the *Great Western Company of California v. Commissioner of Internal Revenue* case (297 US 545).

[7] Accounting Research Bulletin No. 18, December, 1942.

[8] This is a doubtful case; although the company's annual report shows the write-off to income, the applicable prospectus states that the write-off would be made to earned surplus. It should be further noted that the uniform system of accounts of the *Federal Power Commission* and the *National Association of Railroad and Utility Commissioners* specify that the write-off must be made to surplus. New York allows the charge to income.

[9] The tax saving involved in one case is given in the footnote to the income statement as being $1,092,000, which, if it had been included in the income statement as a charge in lieu of income taxes would have reduced net profit to $4,306,000. According to Accounting Release No. 53 of the Securities and Exchange Commission this would appear to be a proper method of reporting the facts.

[10] Securities and Exchange Commission, Accounting Release No. 53. Proceedings of the 1943 War Conference of the National Association of Railroad and Utility Commissioners, page 255.

The tax effect of certain major transactions undoubtedly is a factor in arriving at managerial decisions, and if such decisions are to be completely reflected in the financial statements it seems likely that some allocation of taxes in excess of the amount payable, with appropriate compensating offsets, is necessary, although, as stated in Accounting Release No. 53 of the Securities and Exchange Commission, a tax loss in instances where a tax saving might have been effected logically should be incorporated in the accounts as well. The extreme alternative to some allocation method may be the elimination of all tax expense from the income statement and its classification in a manner consistent with the present treatment of dividends.

The problem of the proper disposition of unamortized discount and expense resulting from premature refunding in the case of some public utility corporations is complicated, perhaps unnecessarily so, by the presence of unamortized discount and expenses applicable to previously refunded issues—the grandfather and sometimes great-grandfather issues. If it is conceded that amortization should proceed over the original life of the refunded issues, it may be found that the piling up of one or two generations of unamortized discount and expense does not violate that principle if maturity dates are sufficiently distant in each instance.[11]

In general it is unlikely that the amount of discount sustained at the time of issuance of the bonds will be substantial. Therefore, the balance sheet classification of the unamortized discount and expense and the amortization method selected to dispose of this amount, if at all reasonable, will not have any material effect on the financial reports of the corporation. Whether the recognition of the financial loss at the time of refunding will be significant depends, of course, on whether it is significant in relation to net profit or surplus. In any event the financial loss cannot be considered the direct result of the mere act of refunding—it is a recognition of the fact that a contract which was satisfactory at the time it was entered into has gradually, or abruptly, turned into one which is defective enough to warrant cancellation. This deterioration resembles somewhat that of obsolescence in fixed assets, and it should be possible, with the advantage of hindsight, to allocate the loss to preceding years in some equitable manner, since, after all, the reason for the loss is apparent. Because the accountant is required to compress transactions into arbitrarily rigid fiscal periods and ordinarily is not allowed to restate the results of prior periods at will, does not in itself seem sufficient reason to justify spreading the loss over future periods. There is considerable merit to the argument that financial reports should ignore the fiscal period and cover a business cycle. This would facilitate the disposition of losses of the so-called non-recurring type because the cycle is likely to be of sufficient length to absorb adequately the loss as well as being more nearly correct as far as allocation is concerned.

[11] Accounting Research Bulletin No. 2, September, 1939, of the American Institute of Accountants, favors the continued amortization of unamortized discount and the call premium applicable to refunded bonds over the original life of the refunded bonds. Writing off these items at the time of refunding is also acceptable. Other methods are subject to exception, unless specified by a regulatory commission.

The deferral when refunding is effected by the sale of preferred stock (which was done in part by Northern States Power Company of Minnesota in 1937) is defended by William D. Crastoun in the March, 1939, issue of the *Journal of Accountancy*. The Securities and Exchange Commission in the brief Accounting Release No. 10, December, 1938, objected to deferrals unless the bonds were refunded by "other evidences of indebtedness."

HISTORICAL DEVELOPMENT OF COST ACCOUNTING

S. Paul Garner

In order to provide a background for the work of the Committee on Cost Principles, it fell the lot of your speaker to present the developmental aspects of cost accounting from early times to the contemporary period. This brief survey will serve to indicate that cost accounting is not a newly developed offspring from its parent, the accounting process, but rather has been going through its "growing pains" for many decades. In view of its long and interesting evolution, the Committee feels that cost accounting now occupies such a prominent place in the business community that it is opportune and highly desirable for its principles and concepts to be stated in tentative form. Or, to express it differently, the Committee believes that cost accounting has now "grown up" sufficiently to warrant the serious attention which the Committee has given to its area and purposes. The present paper, therefore, will (1) attempt to set the stage for those to follow, and (2) show that many of the cost accounting developments which are often considered to be modern have their genesis in many past decades. It should be emphasized, however, that only the highlights of this evolutionary aspect of cost accounting can be presented in the brief time available. Elaboration on these highlights must be postponed to some future time.[1]

It has generally been believed that cost accounting had its origin in the rise of the factory system in the Industrial Revolution. While it undoubtedly received a major impetus from that source, some of the practices and theories of today are much older. In fact, they date back to about fourteenth century when, as a result of the growth of Italian, English, Flemish, and German commerce, industrial enterprises began to be established by various individuals and partnerships to engage in the manufacture of woolen cloth, books, coins, and other lines. As several historians have pointed out, wherever capitalism began to show itself better accounting practices followed within a short time. Cost accounting, being concerned with those specialized aspects of general accounting which have to do with the recording and analysis of factory expenditures, was no exception to the preceding tendency. It has been suggested, however, that the first definite development in cost accounting took place in the time of Henry VII of England (1485-1509), when a large number of small woolen manufacturers, being resentful of the many guild restrictions, moved to the country villages from the cities, and established industrial communities, hoping to be able to sell their finished products through other channels than the organized guilds. Costing had not been so essential among the group as long as all their factory and selling activities were regulated by the highly monopolistic guilds; but, as many firms have since learned, when the small factory owners found themselves competing now not only against the guilds, but also among themselves, more accurate records of costs became imperative and almost a prerequisite for success. Incentives such as these undoubtedly gave impetus to cost accounting in those years of the Middle Ages.

[1] For a comprehensive treatment of the development of cost accounting the reader is referred to the author's "Evolution of Cost Accounting Theories and Techniques" (now in manuscript form), which will be published in the intermediate future. This work also gives many citations.

Other examples of the use of cost accounts at a very early date may also be cited. For instance, the prominent Fugger family of Central Europe at one time controlled the prolific silver and copper mines of Tyrol and Carinthia, along with a foundry. As early as 1577 the accounting records at one of the mines contained the following accounts: Ore, Lead, Mine and Foundry, General Expenses, Smelting, Freight and Transport, and Iron and Iron Slack Trade. There is no evidence that these accounts were specifically used in the modern cost-flow sense but there are references to such phrases as "cost of production" and "prime costs." In a later year one of the smelter accounts was charged with the cost of operating the smelter while it was credited for shipments. Twenty-three items were listed as debits and the credit side contained nine separate types of entries. It is obvious that there was nothing simple about this!

The methods of costing used by the Medici business interests are also noteworthy as an early indication of the adaptation of bookkeeping procedures to manufacturing activities. This well-known family, in addition to its extensive banking business, was engaged in wool manufacturing for many decades throughout the fifteenth and sixteenth centuries. As early as 1431, some sixty-three years before Paciolo published the first printed text on double-entry bookkeeping, rather complete sets of books were in use in the Medici industrial partnerships. An account called "Cloth Manufactured and Sold" was drawn up, and a statement prepared which purported to show the profit on all the cloth that had been sold. The debit side of each cloth account contained sums for representing (1) the wool purchased, (2) cost of dyestuffs, and (3) the amounts paid out for other manufacturing costs, such as wages, oil, cards, and teasels. Improvements were made in the accounts of these industrial partnerships as the decades passed by, and, during the sixteenth century, several innovations are to be found. Time does not permit a comprehensive treatment of these, but anyone at all familiar with modern cost-accounting techniques will recognize (upon a detailed study of the Medici accounts) that some of the current practices are quite evident in the old Medici records. The methods were crude, of course, compared with later techniques, but the astonishing thing is that the systems worked as well as they did. The development of what was at that time called a "wage ledger" was quite original; it was a distinct forerunner of the modern factory ledger which is integrated now with the general accounts of the industrial enterprise. It may be concluded also that the bookkeepers who handled the complex records which were kept must have been experts in their line of endeavor because even today the system used by them would be considered slightly complicated and technical in nature.

The Plantin accounts (he was a Flemish printer and publisher of the sixteenth century) contain many elements of a modern job-order cost system. A separate account was established by Plantin for each book which he undertook to publish. These accounts were debited for the paper used, wages paid, and other costs of printing. After the book had been completed, an entry was made transferring the special account to another one named "Books in Stock." Incidentally, in connection with both the Paper Stock and the Finished Books accounts special columns were provided for recording the quantities—a type of perpetual inventory.

Several other examples of the early interest in cost accounting could be cited, but enough has been indicated to show that certain modern cost techniques and practices had their origin in the period

1400-1600. Even the purposes of the early systems appear modern, in that they were set up (1) to establish accounting control over the steps of production and (2) to curb waste in the use of materials and labor. It should not be inferred, however, that the types of cost accounts cited above were adopted by many of the comparatively small industrial firms of that time. A more accurate conclusion is probably to the contrary, in that the business units referred to were undoubtedly forerunners, not only in production techniques but also in its concomitant, cost accounting.

As far as the literature on cost accounting is concerned it was conspicuous by its rarity before the beginning of the Industrial Revolution. The examples of cost accounts cited above are important, however, as they indicate the adaptability of the science of double-entry. With the rapid growth of the engineering, coal mining, and textile industries in the latter part of the eighteenth century, a number of economic problems arose, principally in connection with the large amounts of capital sunk in plant equipment and transportation facilities. Several of these problems are still pertinent and require the complex cost records found in many firms today. For the sake of emphasis a few may be enumerated: (1) An adequate supply of raw material and the records pertaining thereto would be wanted by the managers, as it was soon recognized that too much inventory could be kept on hand; (2) the larger payments made to employees required a system which would tend to diminish payroll frauds or errors; (3) the problem of depreciation became much more important in view of the more costly equipment used, and the obsolesence factor; (4) in view of the keen competition which began to prevail, it was essential that the managers know to what extent prices could be lowered in dull seasons, and yet cover the already familiar prime costs; in other words, variable and fixed costs became significant even at that early date; (5) the transfer of product from process to process needed to be watched and recorded carefully, with the costs being compared from period to period.

Many other cost problems of like nature arose, not only in the iron and steel industry but in other industries as well. For example, the accounting for the machinery producers (steam engines, textile, and railway equipment) offered many interesting perplexities, especially since it was the custom to estimate costs and tender bids to prospective buyers. What was more logical than to take the next step; that is, after accepting a contract for a certain project, to keep some sort of collective details to provide information for more reliable future estimates? Obviously, this is what is known today as job-order costing, and some of the modern cost accountants' most difficult problems grew out of those humble beginnings. All of the later familiar controversies concerning the allocation of burden to jobs, whether to include imputed interest as a cost, handling of scrap, and the coordination of the cost and general financial records, can be traced to the same source. By-product and joint-cost problems also became increasingly important as industrial chemistry gained a foothold in the early 1800's. In addition, the extension of railway systems combined practically all costing problems, such as depreciation, large burden costs, shop costs, joint costs, and the control of far-flung, integrated business organizations.

Just because all the above problems existed does not by any means imply that they were solved overnight. Indeed, some of them are still with us and have been the subject matter of deliberation of your Committee on Cost Principles. It should also be emphasized that the development of cost has been a very gradual process—

natura non facit saltum—and the tracing of its early evolution is made difficult by fact that the persons who worked on the problems in the nineteenth century seem not to have been the type who wrote down, to any large extent, their ideas and techniques. The cost accountants and bookkeepers passed their methods on to others only with great reluctance; strict secrecy was often the rule. Then, too, there were few theoreticians, that is, persons interested in the subject from a impartial viewpoint. It remains a partial mystery, however, that there was no dearth of texts and other expositions on commercial bookkeeping, several dozen having come down to the present; yet, it is rare that any of these volumes mentions cost or manufacturing record keeping and its many problems.

In view of what has been stated above, it is entirely natural that among the first writers to mention factory accounting specifically should be Englishmen, as that country was the first to be faced with industrial problems. Later on it would be natural for the United States accountants to take over part of the lead, along different lines perhaps but nevertheless the lead. The development of industrial accounting in the two countries definitely supports this conclusion.

Cost accounting developments during the first seven or eight decades of the nineteenth century consist principally in a moderate refinement in the procedures necessary for the ascertainment of prime costs. While there are two or three striking exceptions, the cost literature of the period is conspicuous by its absence. As a matter of fact, the few exceptions seem to have been to a large degree distinct forerunners of the authorities who appeared on the scene around the turn of the twentieth century, rather than indicative of the cost practices and thinking of the early and mid 1800's. There is some indication, however, that the importance of costing was not entirely overlooked. One early (1841) exponent of scientific management, for example, mentioned that each producer should be continually on the watch to discover improved methods by which the cost of the article he manufactured could be reduced; he stressed the importance of knowing the "precise expense" of every process, as well as the "wear and tear" of the machinery which was used in the making of the product.

In spite of such references, it may be stated that most factories during the period prior to 1890 simply modified the familiar trading account to take care of the factory charges. The primary goal was, therefore, the derivation of an interim profit figure rather than the cost of production. The concept of flow of cost through the ledger which is widely adopted today was relatively unknown; no sharp distinction was made between the "shop burden" and the commercial expenses of the firm. Further, the use of cost accounts to aid in determining appropriate inventory figures for partially finished and finished goods was generally slighted.

Cost accounting theories and techniques came into their most fruitful period of development in the early 1890's and around the turn of the century. It was during this period that (1) the mechanics of the integrating of the "factory accounts" with the "general accounts" were finally worked out; (2) the details involved in handling and recording the raw material of the factory were thoroughly discussed (including the problem of pricing material into production); (3) the details associated with the recording and assignment (to product units) of labor costs were comprehensively treated—in fact, little new has been added since that time; (4) the items of manufacturing burden to be included in factory cost of production began to be seriously considered, and there appeared

brief references to the fixed and variable cost classification which is so widely used today in flexible budgeting. It should not be understood, however, that any of these developments occurred overnight. The struggle which went on, for example, in working out the problem of integrating the cost and financial accounts cannot be appreciated without a careful perusal of the literature devoted thereto during the period.

The years from 1900 to 1915 were principally devoted to (1) refining the cost flow technique and (2) to the question of the appropriateness of the use of predetermined burden rates. Closely allied with the latter problem is all the controversy concerning the handling of idle plant capacity. It should be noted, however, that the matter of predetermined burden rates received considerable attention before the question of idle time became important. Until 1900 there were very few cost accountants who viewed the burden cost problem as being anything other than historical in nature. After that date the various authorities began to refer more and more frequently to "estimated rates" and those based on "experience." One writer, for example, suggested that the rate should be varied depending upon whether the firm anticipated a "brisk, medium, or dull business."

The fact is not generally recognized that industrial engineers made as many contributions as accountants to the development of cost techniques and theories during this period. The names of the early exponents of scientific management recur throughout the developments in cost accounting during the first few years of the twentieth century. Their work was closely allied to the refinements in burden application rates based on the capacity to produce rather than the actual production of the firm. As early as 1903, the difference between the two was called a "dead charge." Comparatively few firms, however, adopted this advanced thinking as to the nature of cost, but it made the path less difficult for those who followed in later years.

By 1915 the basic structure of factory cost accounting had been completed. Subsequent developments centered around the growth of interest in distribution and standard costing, with their emphasis on cost analysis and control, flexible budgets, and costs for special purposes. There has been also a great extension of the ideas of scientific shop management into the accounting control of large-scale production. Many problems were treated, however, on an individual firm basis; that is, each business unit to a large degree took the position that its needs for cost data were unique and peculiar to it. As noted previously, this same feeling had been existent for many decades past. In more recent years, on the other hand, the increased recognition of the social and economic consequences of cost accounting has caused the profession to take stock of itself and to appraise critically the desirability of continuing the older view that each manufacturing enterprise is for cost accounting purposes an independent proposition. The full implications of this transition of emphasis have not as yet, of course, been fully explored. However, in view of this trend, it is obvious that the time is opportune to develop the rationale of cost accounting.

THE DEPARTMENT STORE CONTROLLER'S PART IN BUSINESS POLICY

JOHN W. PAYNTER

THE BUSINESS policies of a department store, like any other sound business enterprise, are finally decided by top management, generally the corporate officers or the Board of Directors. These policies, once laid down, must be administered by the next immediate echelon of operating personnel consisting of the merchandise manager, the general superintendent or store manager, the publicity director and the controller.

During the prewar and war years, management looked to the controller principally for the solution of technical accounting and credit problems, routine report and statement preparation, store-system-affecting control procedures, internal auditing, taxes, and government regulations. While these things are just as important as they always have been, other phases of the controller's function have become much more important; in fact, have attained ranking equal to that of the more customary control division problems.

If the controller is to carry his full share of the management load, he must, in addition to finding more economical methods of performing the control functions effectively, work closely with the merchandising, operating, and sales promotion members of management in order to be in a better position to perform constructive services for them. Now, more than ever before, an effective job and satisfactory results in the other divisions are dependent upon the tools with which they are supplied to do the job. Tools in the form of effective reports issued on an earlier schedule, adequate and accurate interpretations, special analyses, and aids for the effective control and reduction of costs are all necessary to the welfare of the other divisions of the business.

This change in the control function has been taking place gradually and is not a result of the war and of postwar problems. It is the result of increased demands by all branches of the management. If this change had not come about through the needs and requests of other branches of management, it would not have been accepted willingly by them and would, therefore, have been far less beneficial to the business.

One of the major problems in retailing today, from the controller's viewpoint, is that of adequate merchandise controls. During the past few years merchandise controls were discontinued in many stores, but not in ours, because merchandise was scarce, buyers were eager to purchase almost any type of commodity, and in some departments, sales and turnover were entirely governed by the availability of forward stocks.

This situation has changed rapidly. Today in a large number of the merchandise lines, salesmen are again on the road, calling on the buyer, with adequate quantities available for almost immediate delivery. Other lines of merchandise will gradually come into adequate supply and in the not-too-distant future supply will again generally equal the demand.

Merchandise controls, properly developed and adequately maintained, when mixed with a little common sense and sound judgment, can accomplish these things:

1. Prevent under-buying when demand for an item is growing.
2. Forestall over-buying when the demand has reached its peak or has begun to decline.
3. Lower markdowns because of over-buying being forestalled.
4. Increase turnover, because inventory investment will not get out of hand.

5. Reduce interest costs.
6. Provide specific information of many kinds, and types which cannot be obtained in any other manner.

In our organization the Control Division has a staff of approximately two hundred people engaged in doing all merchandise clerical functions, including the maintenance of merchandise controls on a day-to-day basis for the merchandising and buying personnel. These controls are kept as simple as possible and might not be what a special-service analyist of the accounting profession would recommend or install for his client.

They fall into three general groupings whereby each line of merchandise may be analyzed and controlled by price line, color ratios, manufacturers, size scales, model ratios, fabric ratios, and pattern ratios.

One type shows the physical inventory on hand at the beginning of a period—a week, two weeks, or a month, depending upon the need—adds to it the receipt of incoming merchandise, and arrives at "sales" by subtracting the quantity of merchandise on hand at the close of the period as determined by a physical inventory.

In many of our selling departments especially Ready-To-Wear, the posting of sales is done from the stubs torn from price tickets. If the department is featuring a special promotion, the posting may be done hourly throughout the day of sale; otherwise, the work is completed on the following day.

In other departments sales analysis is done manually from tissue copies of the saleschecks on the day after the sale. In still other departments actual perpetual inventories are kept. This method applies to such merchandise lines as men's clothing, furniture, electrical appliances, and certain types of houseware of large unit value housed at remote warehouses.

These records are maintained in areas immediately adjacent to the selling floors and are available at all times to the merchandising personnel. When the buyer goes to market pertinent information from these records goes with him. If he is to be in the market for any length of time the information will be forwarded to him at frequent intervals.

A buyer who has access to proper merchandising records has a marked advantage in the market. His purchases are planned in ratio to prior experience and future planned sales.

All of the elements of good merchandising have been properly analyzed and he knows the answers to the following questions before making his firm's commitments to manufacturers:

1. How many dollars he will spend.
2. How many units he will buy.
3. What price lines he will buy and how many units in each.
4. Planned sales.
5. Current inventory.
6. Planned receipts of merchandise.

We believe that the management of our firm when furnished with proper merchandise-experience figures can plan future inventories, sales, finances, and policies intelligently.

Another important problem of the retail store controller is the control of expenses. Since it is customary to measure these as a percentage of sales, the amount of rise has been concealed by a lowering of percentage ratios. Reviewing the general average for department stores as set forth in the *Harvard Report*, it is noted that with a sales gain in 1945 of 105 per cent over 1939, total expenses increased 61 per cent. The major portion of this increase is in payroll costs which showed a rise of slightly over 77 per cent. All other expenses increased about 43 per cent. Similar figures for the year 1946 have not as yet been released, but we know, based upon pub-

lished statements of a partial list of stores, that they will show a substantial increase over 1945. While all this is true percentagewise, the cost per sales transaction has been steadily climbing. If we are faced—and everyone in the retail field believes we will be—with a decline in the dollar amount of the average sale and fewer sales transactions, or even the same number of sales transactions, our profit potential will rapidly disappear because wage rates are frozen on a high plane.

Fortunately, department store operations afford an excellent basis for the establishment of standards of performance for workers. Based upon experience records of the number of transactions completed by each department and the number of employees required for past years, we set employment quotas on a monthly basis. These quotas must be followed by the department supervisors.

Recent increases in individual wages and salaries make it impossible to control payroll costs by the reduction of dollars paid to employees. The alternative then is to increase efficiency and production to the point where the required work can be completed with a fewer number of employees.

To this end, we have established, within the past ninety days, an inventory of personnel skills of the eight hundred employees of our Controller's Division. This inventory is based upon the employee's education, work experience, hobbies, and personal desires to do a particular job or type of work for which he feels he is most qualified. With this information, we expect to correct malassignments resulting from wartime conditions and assign personnel to the job which affords the greatest opportunities for the use of his particular skills and a possibility for advancement. Experience has proven that a satisfied employee is by far the best producer.

Proper training of employees is also a factor in reducing payroll costs. Reference and procedure manuals, setting forth the detailed operations of the various accounting and credit departments, are being prepared for the use of new employees as well as employees being assigned new work within the department. Members of the Controller's staff have taken an active part in the training program of other divisions of the store, pointing out the close relationship between their work and the work of the accounting department.

In an effort to reduce other operating expenses, we are constantly seeking new improvements in equipment, furniture, fixtures, methods and procedures. Very little of the present furniture and fixtures used by our accounting and credit personnel is of the conventional office-type design. Most of it was designed and built by us to meet our requirements for accomplishing a more efficient operation with the least amount of lost motion or exertion.

It is with a great deal of enthusiasm that our organization is beginning a long-range program of work simplification. The Control Division is the first of the operating divisions of the store to begin such a program. We are now taking movies of specific accounting operations which involve equipment, personnel and methods.

The first movies will be very detailed and will show all parts of the operation, including machine operations, hand movements, handling of records, etc. These movies will then be shown to the employees of the particular department for study and suggestions. Supervisors will then study them for operations which might affect other departments. Simplification in equipment or procedure resulting from the film will be made and then the operation will be rephotographed. After the second film is shown and studied, the simplified procedure, with any necessary minor revisions, will then be put into effect.

We feel confident that this program will

assist us in reducing our operating costs. Just recently, we saw a check-cashing operation photographed by a store which has been engaged in a similar work-simplification program for approximately two years. Included in their film was an operation, identical to one in our store, which had been simplified as a result of their original filming but which we were still doing the same old way. The following morning a change in our business policy was made to give effect to the simplified procedure. This resulted in improved customer service and less handling on the part of the accounting personnel.

Many of the strictly accounting technicians may have the feeling that what I have said has very little, if any, bearing upon the subject of accounting and its relation to business policy. Based upon textbook theory, I might be inclined to agree with them. However, through everything that has been discussed here runs a thread of accounting techniques. The emphasis has been the need for carrying such techniques through to the point of benefit to every branch of the business. There has been an attempt also to talk of speed—shorter time lapses between the occurrence of an event and the recording and reporting of that event—and finally there has been an attempt to tell you that accounting, at least in an organization such as ours, is a process of seeking the best manufacturing techniques to enable us to produce a fast, dependable and low-cost tool which has a very positive effect on shaping business policies because it is not a dusty, historical record over which to hold post-mortems, but instead it is a live, current force from which such policies can be created.

THE USE OF ACCOUNTING IN BUSINESS POLICY DETERMINATION*

HARRY R. EDWARDS

IN APPROACHING a subject such as this, one finds the material so plentiful that his difficulty in a fifteen-minute talk is to confine his efforts to the bare outline of only a few of the problems encountered every day in the retail business. I shall try in this very brief period to sketch from my experience several cases in which accounting furnishes management with the necessary tools for formulating policy.

The importance of accounting reports in guiding management in everyday business policies cannot be overestimated in the retail business. The figures contained in these reports are scrutinized daily, weekly, monthly, and annually. On the basis of these reports, management determines its policies, alters them from time to time, corrects its plans on the basis of changing trends shown therein, and, at the close of the period, checks its performance by them against its predetermined estimates. In all of these activities, the accounting figures play a vital part. They are not static, historical legends when management utilizes them; they become living, dynamic partners in the business, speaking to those who are listening for their hidden meanings and who can interpret them.

Let me mention a few of the reports which serve as daily tools for retail management, and the periods covered:

1. Sales—daily, weekly, monthly, and annually
2. Orders placed and cancellations—weekly
3. Purchases—weekly, monthly, and year to date
4. Stocks—weekly
5. Markdowns—weekly
6. Markup percentages—monthly
7. Financial statements consisting of balance sheet, operating statement, and expense statements—monthly, year to date, and annually
8. Personnel information—number of people, number of employee hours, and pay-roll cost—weekly
9. Production figures such as dollar-sales per employee, and selling cost, as well as number of units of work performed in nonselling departments. An example might be number of accounts-receivable statements posted per hour—monthly

In addition to these numerous internal reports which are submitted to our management and operating personnel, many of the same figures are submitted to statistical agencies, such as the Controllers' Congress of the N.R.D.G.A., the Retail Research Association, Harvard University, the Bureau of Business Research of The Ohio State University, and Federal Reserve Bank Research Departments, where they are tabulated and compared with the figures of other organizations; thus, many valuable business indicators are made available to contributors.

All of these reports, prepared and analyzed by our accounting departments, are the everyday "meat-and-potatoes" variety of accounting information, but let's not minimize their importance; they are the daily guides to alert managements and they indicate current trends which are really used in our business.

When a business organization enjoys growth beyond the capacity of its physical plant location, it becomes necessary to decide whether additional facilities are to be procured to continue that growth or whether other steps are to be taken. We

* The three papers appearing herewith were presented at the Ninth Annual Institute on Accounting at The Ohio State University, May 16 and 17, 1947.

sometimes find that increases in volume are not the only contributors to a more profitable operation, although volume is a powerful factor in any business venture. It may be more desirable in some cases to analyze additional business potentials and screen out just the additional business which produces the most profit. Everyone of us has witnessed the disastrous results of promiscuous overexpansion.

I remember one case in particular where a small manufacturing operation was carried on in a crowded building. Production lines were cramped, lighting was bad, working conditions were, to say the least, difficult. The demand for the product grew rapidly and because of its low-cost position, the company figuratively "coined money." Management obtained a new factory site, installed a beautiful production layout, provided excellent working conditions for its employees, and then the blow fell. A large competitor came into the field, the company's market had to be shared and the small, new plant suffered a major curtailment of its production. Moral: Be conservative in your expansion plans.

In the retail business the solution of the problem of expansion beyond physical plant capacity may be found in a number of moves. I shall mention three and the type of accounting information which would be submitted to management to assist it in making its decisions in the case of each.

Branch Stores

The advantage of branch stores, of course, would be the diversion of the volume growth to remote locations in suburban shopping centers or smaller towns in the hinterland where rental costs are lower than corresponding expansion costs would be at the main store location. An opportunity would also be presented to tap a new source of sales potential. I shall not mention the many merchandising considerations which would go into making a decision for branch stores, but the accounting information necessary for management's consideration is briefly as follows:

1. Cost of branch store building—either purchased or rented.
2. Costs of transferring merchandise to that location.
3. Maintenance costs.
4. Personnel costs and organization.
5. Estimate of sales potential.

These are only a few of the items which would have to be forecasted before a decision could be made to establish such a branch location. Needless to say, the preparation of accounting figures would be necessary and most of the facts would have to be compiled from either existing accounting records of the main store or by reference to the figures and experience of other similar businesses.

Remote Warehouses

Another method of providing for additional growth is the establishment of remote warehouses in order more efficiently to utilize the space at the main location for the all-important sales activity. Here the considerations would be:

1. Cost of warehouse building either by purchase or rental.
2. Cost of insurance and taxes.
3. Cost of transportation to warehouse and transfer between warehouse and store.
4. Cost of pay roll and operating organization.

Accounting information intelligently prepared would undoubtedly be necessary in order to recommend or reject such a plan.

Relocation of Non-merchandising Activities Away from Main Store Location

In order to free the main location for fuller utilization of its space in selling, an

analysis must be made of non-merchandising activities with respect to the need of their being near the selling activities. Certain operations, such as workrooms, service departments, and some office departments, may be carried on just as efficiently at remote locations as at the main store. Here it would be necessary to analyze rental costs and operating procedures in the new location as compared with the present location. The contacts of the department with other departments, cost of moving, materials, communication, and the transmission of reports would have to be scrutinized. Accounting records would be called upon to furnish much of this information.

In many instances in order to carry on one type of business successfully, it becomes necessary to acquire the control of another business to insure continuity of supply of merchandise or service. In the manufacturing business we often read of a processor acquiring a mill, or of a steel plant acquiring a mine. In a retail business it may be a warehouse company or an appliance distributor. When this step is necessary, the organization to be acquired must be examined as to its financial history and operating record, its current financial condition, and its prospects for the future. This determination is an accounting job. The decision to acquire depends largely upon the information obtained from an accounting investigation. The determination of the current financial position undoubtedly would require an audit by a certified public accountant but much of its supplementary data regarding history and future prospects would be developed by the accounting staff of the acquiring organization. The extent and nature of the information to be obtained would be the responsibility of the accounting executive.

At this point another phase of accounting becomes involved. In the acquiring of assets or capital stock of another organization, the impact of taxes (federal and local) must be investigated, and these data will have an extremely important influence upon a decision to acquire or reject, or the manner in which the acquisition was performed. In one case in my experience, purchase of assets would have been desirable. Time does not permit the description of an example of this type of transaction; however, the problems encountered are many and accounting and tax techniques play a major part in the policy making.

One of the most important of the retail accounting executive's tasks is the supervision of credit activities. This consists of three major functions which are described as follows:

Credit granting. This phase starts with the opening of a customer's account. Information as to the customer's personal qualifications for credit are obtained from the applicant and this information is checked independently with credit bureaus, banks, and other references. This phase also includes the authorization of individual purchases as made, and the scrutiny of credit limits which have been established in the opening of the account.

Collections. This function consists of analyzing the customers' accounts continually to see that payments are in accordance with agreements made at the time the account was opened, or later. When payments lag, collectors must notify the customers of their delinquency and follow up the notifications to achieve collection. Occasionally it is necessary to adopt stringent methods to attain collection of difficult accounts.

Credit promotion. This is the good will mission of the credit department. Inactive customers are contacted to determine the reason for their forebearance. New arrivals in the city are contacted to bring them into the credit family. By analyzing the accounts, selected groups of customers'

names may be furnished to the selling staff for special merchandise promotions. The credit records are one of the organization's most treasured possessions.

It is common knowledge that by the tightening or relaxation of credit policy, a decided effect can be produced upon sales. The accounting executive must be alert to the possibilities offered in this connection. He should be able to find that intangible line where credit losses balance the profit produced by additional sales, at least within reasonable bounds. Credit policy may then be set to capture this lucrative additional business without endangering the financial condition of the company. Many a credit manager has shut the door on thousands of dollars of profit by an overcautious credit policy. On the other hand, we find those who are entirely too lax in credit granting—to the detriment of the profit picture. The accounting executive, through analysis of customers' paying habits and of profit margins, is equipped to render an invaluable service to his management in making recommendations as to credit policy.

In this presentation I have attempted to hit the high spots in mentioning phases of policy determination which are influenced by accounting. The point that I wish to make is that just as in an orchestra, each instrument contributes some essential part to the selection, so in business operation, each facet of accounting reflects a particular, essential phase in order to guide management in the achievement of its goal—a profitable venture.

Myron S. Kem

The importance of the accounting department in the determination of business policy has been ably impressed upon all of us during this Ninth Annual Institute on Accounting. This has been effectively presented to us. Surely, we who are here see our responsibility. We must put our efforts and resources to the most effective use of the wealth of information which we as accountants have available. When management is properly informed about all the activities of the business, it is only natural to assume that management will make decisions based upon the facts presented in the accounting reports.

The accounting department must furnish management information which will enable them not only to control, but plan future policies, as well as more readily control current operations. The soundness of any program is judged by its financial aspects. I will endeavor in this talk to outline some examples illustrating the use of accounting in business-policy determination.

A wealth of information is available on budgets. The most important feature of budget installation is the adaptation of the proper type of budget control to suit the needs of the peculiarities of the individual business. Briefly, I would like to emphasize three basic elements which, among others, are essential to sound budgeting practice.

1. A projected profit-and-loss statement must be based upon soundly predetermined or standard costs. It should be pointed out that the predetermined or standard cost often has failed to bring to management a maximum of benefit because historical averages have been substituted for engineered specifications. Such standards naturally contain all of the mistakes of the past and do not include current developments and future engineered changes.

2. A variable operating budget projecting operations at different levels of produc-

tion and sales volume is recommended so as to inform management of the profit or loss to be obtained at various volume levels. The crossover chart is generally used for effective presentation to management. It is my opinion that the intelligent determination of the "break-even" point will assume more importance in business operations.

3. A balance sheet must be projected in order to determine the estimated capital required to finance the operations as proposed in the profit-and-loss budget. This will enable management to determine in advance the need for additional financing and to make the necessary arrangements for it in advance instead of waiting until the need for financing is at hand.

After the predetermination of future operations as soundly as possible, accounting can undoubtedly be of much greater assistance to management by reviewing the character and scope, as well as the readability of its periodic reports.

I have selected two subjects which may stimulate creative thinking in reporting on your own particular operation.

Inventory Analysis

Production capacities have multiplied and it is reasonable to assume that sooner or later there will be a surplus of goods. When this occurs, the ability of management will again be tested in a highly competitive market, inasmuch as the consumer will not pay a price which includes the cost of production inefficiencies or excesses in the cost of distribution, which have occurred as a result of our lessened efforts at cost control during the war years. This indicates the need for a much closer study of the accounting records relating to the inventory—an important item in the working capital of most companies. Because of the scarcity of raw materials, it has been necessary in many cases to make commitments far in advance. These commitments are based upon production and sales estimates, but in the event of a sharp break in the market price for the merchandise, a commitment position could very well use up all the working capital of a company. The following inventory information should be available at least once a month or more frequently, depending upon the commitment exposure of the company.

Description	*On Hand End of Month*	*In Transit End of Month*	*Commitments Outstanding End of Month*	*Total Inventory and Commitments*	*Consumption This Month*	*No. Months' Supply Based on This Month's Consumption*	*No. Months' Supply Based on Production Schedule*
Inventory:							
Item A	$ 8,000	$2,000	$30,000	$40,000	$10,000	4	3
B	19,000	1,000	60,000	80,000	20,000	4	3
C	12,000	3,000	45,000	60.000	15,000	4	3
D	9,000	1,000	30,000	40,000	10,000	4	3
Total	$48,000	$7,000	$165,000	$220,000	$55,000	4	3

Your attention is called to the commitment position compared to the inventory on hand, and its possible effect upon the working capital which is not disclosed in the normal financial statement.

This same type of information should be available for "finished goods inventory," except the number of months' supply on hand should be based upon latest sales esti-

mates or the sales budget, assuming that the sales budget is flexible. The following finished goods inventory report should be made available to your management at least once a month:

Class of Product	*Production Current Month*	*Shipments Current Month*	*Inventory on Hand*	*Number Months' Supply*	*No. Months' Supply Based on Budget Requirements*
A	$ 5,000	$ 4,000	$ 4,000	1	1
B	25,000	30,000	45,000	$1\frac{1}{2}$	$1\frac{1}{4}$
C	50,000	35,000	17,500	$1\frac{1}{2}$	$1\frac{1}{4}$
D	20,000	10,000	40,000	4	$2\frac{1}{2}$

general classification of product. The only deviation possible between these percentages should be the deviation in ratios among the sizes or types within product classifications, or the failure to maintain established selling prices.

Analysis of Sales

Painstaking and intelligent effort should be given to the preparation of sales analyses by the accounting department. The following studies of sales may contribute helpful information to the management of many companies:

A. An analysis of sales by general product classifications. This analysis should be grouped by "class of customer" or "channel of distribution," and should portray the following information:

	Actual	*% to Sales*	*Budget*	*% to Sales*
General classification of product				
Number of units sold				
Net sales				
Standard cost of sales				
Factory variances				
Actual cost of sales				
Actual gross profit				

This analysis reveals the standard cost and the per cent to sales of such cost that was actually attained as compared with the predetermined expectancy for each

Factory variance applied to gross profit will call for an analysis of such factory variations. Showing factory variance as a separate item is usually helpful in isolating causes for disparities in actual and budgeted gross profit between production costs and sales operations.

B. An analysis of sales by territories. This analysis should show the information given at the bottom of this page.

This analysis is prepared in order to obtain a comparison of performance in each territory or other grouping best suited to the company, measured against the budget, which is the anticipated business

	Actual	*% to Sales*	*Budget*	*% to Sales*
Net sales				
Percentage to budget				
Standard cost of sales				
Standard gross profit				
Salesman's direct costs				
Other (branch office, etc.) direct cost				
Total direct sales cost				

from each territory. The performance of your salesmen should not be measured in dollars alone. Usually, the soundest measurement is against the budgeted volume within the territory. This budgeted volume should be established upon some sound predetermination, such as a market analysis of the potential within the territory, potential new accounts, or myriads of other factors which may be developed by sales or merchandising studies.

If the success of the salesman is meassured by his dollar volume without such analysis as herein described, a good salesman can be classified as a poor salesman and, vice versa, a poor salesman, because of his large dollar volume within a good territory, can be classified as a good salesman. This analysis will measure the results obtained in the territory as related to a properly determined potential existing in the territory.

The standard gross profit in many companies may be inadvisable to disseminate throughout the sales organization; however, it is well to consider whether this information may not be of value to the sales management in knowing the contribution a territory makes toward the support of operating expenses.

I have not attempted to interpret the examples which were given in this paper. The interpretation is not an academic problem, but far transcends the accounting report. In my opinion, the interpretation of the information presented in these reports depends upon the particular problems of an individual company and is the function of management.

In this paper I have not given any examples, except for a brief reference to the budget, relating to the control of fixed assets, manufacturing, or administrative expense. If management is to maintain the type of control which will be required to measure the effects upon profit of changing costs, changing prices, or changing volume, analytical studies similar to those presented herein will have to be presented to the management by the accounting departments for all operations of the company.

HARRISON W. WILDER

THE SUBJECT of "Use of Accounting in Business Policy Determination" fortunately lends itself to a broad interpretation and provides substantial latitude in the selection of cases for discussion.

There are probably many situations in which the method of accounting influences the business policies or practices. Illustrative of this are the cases of companies which use the last-in, first-out method of inventory valuation. In many instances the rising unit costs of inventory with the resultant desirability, from a tax standpoint, of not depleting the inventories, has had a substantial influence on the production and delivery schedules in the later months of the fiscal years of those companies.

The extent to which the last-in, first-out method of inventory is used is disclosed in the May, 1947, letter on economic conditions issued by the National City Bank of New York. This publication stated that "of the one hundred largest American manufacturing corporations, based upon volume of sales last year, thirty-six, representing thirty-eight per cent of the total sales of the group, used 'lifo' in whole or in part."

Normally the accounting, except for budgeting and forecasting, follows the establishment of policies and is the means of disclosing the financial results of the application of these policies. Therefore, a large number of cases in which accounting influenced business policy consist of in-

stances where a special accounting investigation, or the installation of improved accounting controls or techniques, disclosed information which led to changes in existing policies. The following highlights of several cases in this category are illustrative of this type of influence:

In the first case, the Company made die castings and stampings, and also performed some assembly work on the stamping materials. The Company was losing a substantial amount of money at the time the accountants were called in. It was found that the estimating procedure was faulty and that there was practically no knowledge of product costs with which to compare the estimates. A standard-cost system was installed, each productive operation was time studied, and daily performance reports were developed. Provision was made for the proper departmentalization of costs for purposes of allocating overhead, since casting, stamping, and assembly work have substantially different overhead rates. Temporary overhead rates were developed for use until sufficient data could be gathered to set actual rates. In the light of the new costs developed, it was necessary to re-estimate each job. As a result of ability on the part of the company to ascertain accurate costs, it was able to reset its selling prices in line with such costs with a resultant average increase of twenty-five per cent. This increase, together with the savings made in labor costs through better control, was adequate to yield a comfortable margin of profit.

Another case involved faulty organization with respect to responsibility and authority, inadequate accounting, and untidy plant housekeeping. The lines of responsibility and authority of the principal operating personnel were so poorly drawn that the sales manager had no contact with the factory, the comptroller had no representatives in the plant, and the factory manager was not interested in the development of costs and was furnished with none. The comptroller could not get cost data from the shop in the manner necessary to operate a satisfactory cost system and the sales manager, who set prices, was unable to obtain accurate data as to costs. It is almost axiomatic that the company was losing money under such an operating arrangement. When the accountants were called in, it was obvious that a major overhaul was necessary. It was found that a general housecleaning was needed in order to tidy up the plant to meet ordinary standards. A substantial variation in costs was being experienced which was finally traced to faulty weighing of materials. This was occasioned by failure regularly to clean the weighing mechanism which gradually accumulated wax used in the processing.

It was necessary to change the organization chart to give the comptroller control over the policies and practices in the shop so far as they pertained to preparation of the basic accounting data. This included particularly the timekeeping and material requisitioning procedures. A number of erroneous practices in cost allocation were noted, such as charging trainee labor in full to the job on which a new employee was working. This practice resulted in some jobs showing substantially disproportionate costs which were left completerly unexplained to the sales manager who had made the original sales estimates. The accounting allocations of costs were corrected to syphon off those items which should have been treated as overhead costs rather than as direct charges to jobs. The proper allocation of costs permitted the sales department to estimate selling prices in a sound manner and provided accurate costs against which the estimates could be compared. Also, the factory manager was supplied with accurate cost data which were usable as a tool in con-

trolling operations. The realignment and clear definition of the duties and responsibilities quickly changed the executive relationship to one of teamwork and cooperation which is necessary to profitable operations.

A third case is of interest because of its unusual features in the payment of labor. The company manufactured a rather simple product requiring stamping, assembly, and filling operations. A study of the product costs disclosed that the only means of reducing costs to the point necessary to meet competitive prices was by improving the labor efficiency. The study disclosed that an increase in efficiency of approximately twenty-five per cent was necessary, and schedules were set on that basis. The employees were notified that they could leave the plant upon completion of their required quantities, and would be paid for a full eight hours of work. Shortly after the inauguration of this incentive plan the scheduled production was being completed in about six hours. The method has proved to be of considerable advantage to the company, not only by reason of the decreased direct labor and indirect costs, but also through improved labor relations and a practically guaranteed production schedule. Through stabilized production the company was able to meet its shipping schedules throughout the war as well as to plan its material and financial requirements with substantial certainty.

The next case concerns a company which had several manufacturing plants and also owned and operated most of its own retail sales outlets. Its public accountants were requested to make a survey of the procedures and policies of estimating and cost accounting, and also to consider the methods of measurement of effectiveness of the key personnel in its manufacturing plants and sales branches. The survey disclosed that in many estimates, on which the selling prices were based, the material costs were determined by increasing the standard costs by the average material variance recently experienced. The inaccuracies which could develop in estimates prepared in that manner are apparent, particularly where there are substantial differences in the materials required for the various end products. The procedure was changed to require the use of a bill of material priced at current or anticipated costs. The review of the cost-accounting system showed it to be generally satisfactory; however, the method of allocating costs to the units of the business, and the resultant reports, did not provide management with the information of which the system was capable. It was the management view that the manufacturing and retailing functions were so integrated that the entire operation should be considered as a whole, with the result that the operating statements were prepared in such manner as not to disclose the efficiency of the individual plants and branches.

After a thorough study of the situation, it was recommended that the concept that the operations must be considered as one unit be abandoned and that each unit, both branches and plants, be set up in such a manner that each could be measured by the profit it produced. This recommendation was accepted by the management, and the necessary steps were taken to put it into effect. The first step was to change the basis of billing from the plants to the branches from a so-called "actual" cost to the net price charged to outside dealers. This change fixed the unit cost of finished produced and thereby placed the variations in profit entirely under the control of the branch managers. This opened the way to a management bonus based upon profits. Further, the revised method showed the net results of operating the factory branches as compared with handling all

distribution through outside channels. In the plant operating statements, the cost variances which formerly were allocated to the branches were set out as separate items to focus attention on the variations from planned costs. It was found that each plant manager could control the standards by which his performance was measured and that changes in standards were made whenever the standard and actual costs differed materially. This was corrected to provide for only annual changes except for major factors such as general wage increases. By means of billing the sales branches at the outside dealers' net price, the planned income of the manufacturing plants was established, and the profits of each plant were determinable.

This change in presentation of operating data shifted the emphasis from efficiency measured by standards to measurement by actual profit. It had the effect of encouraging the plant managers to search for means of cost reduction and savings of expenses, rather than for reasons to increase the standards. The results obtained in the short time during which the new plan has been in operation indicate that the change in policy will be highly beneficial.

In another case, the company became alarmed when the ratio of its indirect factory labor to productive labor became double that experienced in its production prior to the war. Its public accountants were given the assignment of making a survey of the plant operations with the primary objective of establishing an incentive system for indirect labor. At the inception of the survey, it was noted that eighty per cent of the indirect labor was represented by the material handling, inspection, and maintenance classifications. An investigation of the cause of the high material handling costs revealed that the function was under the supervision of the planning department and, further, that in laying out the production lines, the engineering department had failed to give proper consideration to the matter of storage of components at the points at which they entered the assemblies. Also, the equipment used in trucking the materials was found to be obsolete in design. To correct the situation as to material handling, the responsibility for the handling methods was placed with the process engineering department, and the layout of the lines was redesigned for greater and more efficient production.

Next was the problem of inspection labor. Investigation disclosed an absence of any scheduling of inspection man-power requirements based upon production schedules. In fact, the chief inspector did not definitely know the stations of several of his inspectors. This source of waste was corrected through the installation of methods of pre-determining the man-power requirements based upon the scheduled production. The maintenance classification was found to include substantial costs for rearrangement of facilities. Although work orders were in use to authorize the work and to state the specifications, costs were not accumulated by orders but were charged directly to the maintenance accounts of the departments for which the work was performed. On questioning the foremen of the maintenance crews, it was found that none expected to reduce his crew upon completion of the non-recurring work, but contended that all of the men would be required for routine maintenance. In order to ascertain the cost of the non-recurring work and to determine the normal requirements for routine maintenance, a separate series of work orders was placed in use for all non-recurring jobs. These orders showed estimated costs and standard time to permit comparison with the actual costs accumulated. No change was required as to routine maintenance, which was handled without accumulation by jobs. This procedure soon disclosed the ef-

ficiency of the workmen and the amount of maintenance labor required for routine work at a time when all the crews were busy. The latter information served as a guide for the manpower requirements when only routine maintenance was required. Upon consideration of the foregoing disclosures, it was concluded that the immediate solution to the problem of high indirect labor costs lay not in the installation of an incentive plan for such labor, but rather in the use of proper controls and adequate supervision.

The solutions developed to the problems which arose in the cases mentioned were tailored to fit the peculiarities of the individual situations. Certainly, it is not contended that the methods recommended in these cases are the preferred methods for use in all similar types of cases. Practically all engagements involving the revision of methods necessitate the adaptation of such methods to the desires of the management and the special circumstances present in the individual cases. However, the cases do show that the information developed from accounting investigations can have a substantial influence on business policy determinations.

THE TEACHERS' CLINIC

S. PAUL GARNER

EDITOR'S NOTE: Several members of the Association have suggested that a section of THE ACCOUNTING REVIEW should be devoted to notes and short articles specifically on the subject of teaching accounting. Many of the experienced teachers, as well as some of the new ones, have developed devices and techniques for the presentation of certain of the knotty aspects of accounting, and it is felt that such suggestions might well be made available to the other members of the teaching profession through *The Teachers' Clinic*. Accordingly, contributions are hereby invited. Please address all correspondence to S. Paul Garner, School of Commerce and Business Administration, University, Alabama.

SUGGESTIONS FOR BEGINNING TEACHERS IN ACCOUNTING

A. L. PRICKETT
Indiana University

Beginning instructors are usually assigned to the elementary course in order to obtain their experience. The large volume of students is also found at this level. The intermediate course presents a somewhat similar problem, although it is less acute. Generally, the courses above the intermediate level are in the hands of experienced instructors. The writer believes that all the ability and skills an instructor can command are required at the first level. If the student fails to learn the fundamentals well, difficulties in more advanced courses may be due to the structural weakness of the introductory background rather than to the advanced course *per se*.

The problems of the beginning instructor are increased not only by the range of interest and ability to grasp the subject but also by sheer numbers. In advanced courses, however, there is the advantage of selection. The suggestions offered here are primarily to help the beginner. They are not intended to be complete. Also they are confined to the elementary course, although they may be applied also to the more advanced classes.

Instructor's attitude and classroom technique. The attitude of the instructor is important. If he feels that his teaching is secondary and his graduate study or other activity the compelling consideration he will probably not be an effective instructor. He does not need to look upon teaching as his future occupation, but he must for the period of his employment consider the work as a challenge to prove his worth. He must also not be unduly impressed with his own training in accounting, feeling perhaps that the first course is merely a necessary impediment and somewhat below his station.

Mechanics can never be offered as a substitute for personal teaching but all beginners can benefit from the methods, devices, and techniques which are developed through experience. It should be remembered that the techniques of one person may not function well for another, particularly if the procedures are somewhat unique.

The best methods are the simple ones. Involved illustrations are not effective, except with the brilliant students who are rare in the beginning class. This rule applies to language, illustration, and procedure. If an area is involved, sub-divide it.

Instruction should not become fixed to a specific pattern, as flexibility and adaptability within the general framework are instrumental in maintaining interest both for the student and for the instructor himself. Class conditions, current questions, and ideas developed by the instructor "at the moment" bring improvement, even during successive presentations on the same day. It is regretted that some of these

extemporaneous performances cannot be *fully* captured for later use.

Rating of instructors. Large departments sometimes ask for student rating of instructors and some instructors seek this information on their own initiative. The latter plan is probably better than the departmental routine. While one has to draw upon common sense to a considerable degree in evaluating such ratings, it must be said that they are not without merit if used occasionally. A rating sheet which has been helpfully employed asks for three degrees of quality on the following points: (1) Interest in subject; (2) attitude toward students; (3) fairness in grading; (4) liberality and progressiveness (particularly tolerance of viewpoints); (5) personal peculiarities (annoying mannerisms); (6) personal appearance; (7) stimulation of intellectual curiosity; (8) preparation for class; (9) presentation of subject matter; (10) organization of the course; (11) specific comments about examinations, assignments, text, class discussion. The rating sheets are usually anonymous. Sincere, honest expression is sought in an objective manner for the good of all concerned. When cooperatively obtained and intelligently used, such information is almost certain to benefit the instructor.

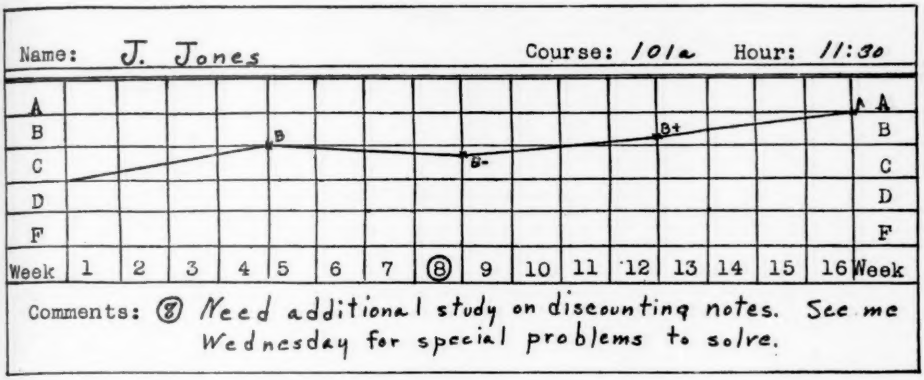
Planning the course. The department should decide just how much subject matter is to be completed during the term. Deducting meetings taken for personnel work, orientation, holidays, and special programs, a net figure remains for hours of teaching, including tests and examinations. The first breakdown of the net semester or quarterly time unit should be based upon natural subject-matter divisions, rather than calendar convenience, school midterm, or other report requirements. The content of each division will differ among schools but an example for the first semester or quarter would be: (1) Completion of a simple accounting cycle; (2) special books of entry and negotiable instruments; (3) adjustments at the end of the period; (4) the voucher system; (5) controlling accounts. Whatever subdivision is selected, the parts do not need to employ the same amount of time nor coincide with some arbitrary date; arbitrary time intervals should not interfere with instruction. A test should be given after each sub-division is covered to show the instructor what has and what has not been learned. Remedial work can then be applied where needed. The final examination in accounting is of less importance than in many other subjects since the learning is cumulative and continually involves the understanding of preceding lessons.

Records. A complete record should be kept currently, for each student, on class participation, problem solving, tests, attitude, attendance, and the results should be cumulative—yielding a "standing to date" after each test. The records should be available every day for the student's inspection and information. The student should know at all times exactly how his performance rates. After each of the five time intervals noted above has been completed, a standing-to-date is cumulated; the author suggests that a graph report like the one at the top of the next page be issued to the student. Everyone starts at "C."

The psychological benefit of the report is significant. It may look like too much work to some beginning instructors, but after once having tried the plan they will not be likely to discontinue it. The students often request the progress reports after they see their benefit.

The complete class record should be filed with the department, as administrative problems which arise months or years later can best be resolved by reference to the record.

Suggestions to students. The instructor



should show the student how to lay out his work in order to avoid fumbling of papers and waste motion. Many students experience difficulty in adding a column of figures which they have entered in a column where dollars and cents rulings have not been provided. The simplest suggestion which can be given is to establish figure position habits so that the three following amounts will be written thus:

44627.31 57832.45 6428.92	instead of	44627.31 57832.45 6428.92

Classroom manner. The instructor should stand throughout the class session, directing the activity according to a written plan which he has previously worked out in the rough and filled in as to significant points of emphasis. The author suggests that he never take a manual of solutions to class with him. Visual aids, however, are indispensable. The best aid yet devised is the familiar blackboard. Films, film strips, slides, opaque projections, charts, and other devices have been experimented with, but they probably never will take the place of the blackboard. A room is seldom assigned solely to one instructor for the entire day, so he may have little opportunity to set up an illustration prior to the meeting of the class. Clear visibility, even though the instructor has seen to it that students with poor vision have been assigned seats at the front, very definitely limits the detail and extent of an illustration. This difficulty may be overcome in part by means which will be shown below. The instructor should not "talk to the blackboard," except for very brief unavoidable moments. The hard-of-hearing should, of course, always be seated to their best advantage.

Types of illustrations. To resolve confusing transactions, once the principles of debit and credit are generally understood, the instructor can adopt no better device than the simple "T" account.

Example:

A B Company owes us $600; we owe them $5,000. We settle the accounts by:

(a) Giving them delivery equipment which cost us $2,000, against which a reserve for depreciation has accumulated to date of $1,500.

(b) Giving them our non-interest bearing 30-day note for $1,000 which they accept at its present discounted value. (Assume that the discount rate is 6%.)

(c) Giving them a note receivable which we hold, dated April 1, face $1,000, 6%, 60 days. Twenty days have elapsed since we received the note. The discount rate is 8%. A B Company takes the note at its present discounted value, that is, the value on the day we give it to them.

(d) Giving them cash $1,893.

(e) Discount they allow us for payment. (For the discount use the amount you need to complete the entry.)

A B Company

√600.00	(1) 600.00

A B Company

(1) 600.00	√5000.00
(2) 500.00	
(3) 995.00	
(4) 1001.02	
(5) 1893.00	
(6) 10.98	

Delivery Equipment

√2000.00	(2) 2000.00

Depreciation Reserve—Delivery Equipment

(2) 1500.00	√1500.00

Notes Payable

	(3) 1000.00

Interest Expense

(3) 5.00	

Notes Receivable Discounted

	(4) 1000.00

Interest Income

	(4) 1.02

Cash

	(5) 1893.00

Purchases Discount

	(6) 10.98

Journalizing the above problem according to the following directions is also effective:

I. Make one compound, two-column, journal entry building up the respective debits and credits as you go along, giving all details.

A B Company..............(1)	$ 600.00	
Reserve for Depreciation of Delivery Equipment.......(2)	1500.00	
A B Company..............(2)	500.00	
Interest Expense............(3)	5.00	
A B Company..............(3)	995.00	
A B Company..............(4)	1001.02	
A B Company..............(5)	1893.00	
A B Company..............(6)	10.98	
A B Company............(1)		600.00
Delivery Equipment.......(2)		2000.00
Notes Payable............(3)		1000.00
Notes Receivable Discounted................(4)		1000.00
Interest Income...........(4)		1.02
Cash....................(5)		1893.00
Purchases Discount.......(6)		10.98

II. Condense the entry above into one compound entry, combining amounts for like titles where feasible.

A B Company................	$5000.00	
Reserve—Delivery Equipment Depreciation.............	1500.00	
Interest Expense...............	5.00	
A B Company..............		$ 600.00
Deliv. Equip................		2000.00
Notes Payable..............		1000.00
Notes Rec. Discounted.......		1000.00
Interest Income.............		1.02
Cash......................		1893.00
Purchase Discount...........		10.98

One of the most simple types of blackboard work is an application of the directional arrow system illustrated as follows:

Expense

900	900 →

Profit and Loss

900	1200 ←
300	

Income

1200	1200

Dividends Paid

200	200 →

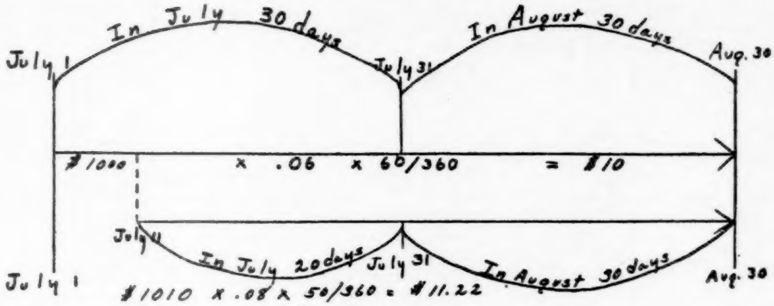
Surplus

200	300

Discounting interest-bearing notes is always troublesome for the student. The beginning instructor can aid him with a progressive diagram, based upon the following facts:

J. Jones gave the business a $1,000, 6% 60-day note, dated July 1. The note was discounted on July 11 at 8%.

Emphasis is placed on the direction of left to right, and time computation. The



$1,000.00	Face
10.00	Interest
$1,010.00	Maturity Value
11.22	Discount
$ 998.78	Proceeds

1) Notes Receivable..............	$1,000	
J. Jones..............................		$1,000
2) Cash.........................	$ 998.78	
Interest Expense..............	1.22	
Notes Receivable Discounted............		$1,000.00

entire process is divided into steps and each one is stressed. A similar application is easily made to bond problems.

A choice of method to be used in reporting discounted notes in the balance sheet provokes reasoning and discussion. Each of the following is placed on the board and the student indicates the effect of the method on the balance sheet data:

(1) Notes Receivable	$30,000.00	
Notes Receivable Discounted	5,000.00	$25,000.00
(2) Notes Receivable (a)	$30,000.00	

Footnote (a) $5,000 of notes receivable have been discounted.

(3) Notes Receivable $5,000 were discounted	$25,000.00
(4) Notes Receivable	$30,000.00
(5) Notes Receivable	$25,000.00

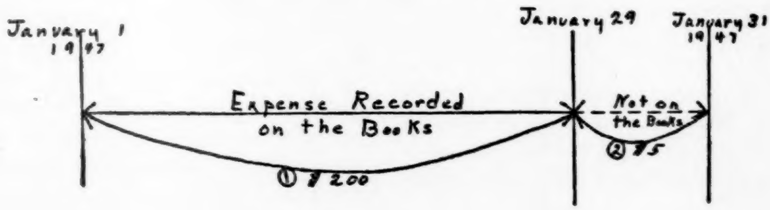
Assets	*Liabilities*
(6) Notes Receivable $30,000.00	Notes Receivable Discounted $5,000.00

Accrued and prepaid items have long been known to cause confusion for the beginning student and no way has been found to reduce the treatment to absolute clearness. The centering of attention on the justification for making the adjustments is helpful. For example, it is pointed out that an appropriate balance sheet and profit and loss statement cannot be prepared from the accounts as shown on the trial balance. Stress is placed on the concept of "Not Enough" and of "Too Much" on the books. These terms are repeated several times in the demonstration. For example, consider Office Salaries.

(1) Office Salaries....	$200.00	
Cash........		$200.00

Set up expense, of which there was not enough on the books, and the corresponding liability increase.

(2) Office Salaries......	$5.00	
Accrued Office Salaries		$5.00



Office Salaries

Debit		Credit	
(1)	200.00	(3) To P&L	205.00
(2)	5.00		
	205.00		205.00

Accrued Office Salaries

Debit		Credit	
		(2)	5.00

Cash

Debit		Credit	
		(1)	200.00

Profit and Loss

Debit		Credit	
(3)	205.00		

(3) Profit and Loss........................	$205.00	
Office Salaries................................		$205.00

The $205 is used in the profit and loss statement, having been increased from $200 to $205, and the $5 accrued is used in the balance sheet. The Office Salaries account is closed to Profit and Loss and no longer exists. Accrued Office Salaries has no further use since it will be incorrect the next day. Close it back to Office Salaries account:

(4) Accrued Office Salaries............	$5.00	
Office Salaries...........		$5.00

Office Salaries

Debit		Credit	
	xxx.xx		xxx.xx
		(4)	5.00

Accrued Office Salaries

Debit		Credit	
(4)	5.00	(2)	5.00

In February the first cash payment will be (let us assume) $200.00.

(5) Office Salaries..	$200.00	
Cash........		$200.00

When posted, the (4) $5.00—credit, and the (5) $200.00—debit, give the correct net result—$195.00 Office Salaries expense for February involved in the entire transaction.

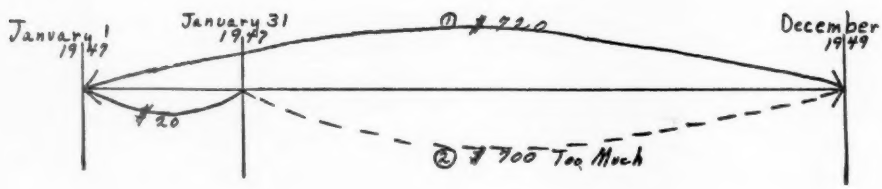
Office Salaries

Debit		Credit	
	xxx.xx		xxx.xx
(5)	200.00	(4)	5.00

Cash

Debit		Credit	
		(5)	200.00

For "Too Much," the purchase of insurance on January 1 for $720.00 for three years is an effective illustration. During January, 1/36 of the total has expired.



Insurance Expense

(1)	720	(2)	700
		(3) to P&L	20
	720		720
(4)	700		

Cash

		(1)	720

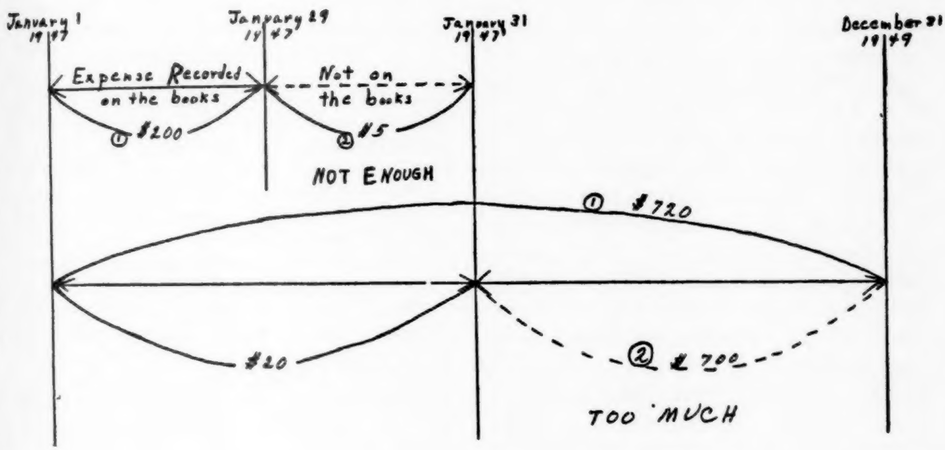
Unexpired Insurance

(2)	700	(4)	700

Profit and Loss

(3)	20		

Combined picture:



EFFECTIVE TEACHING

George R. Husband
Wayne University

Effective teaching is difficult to define and still more difficult to measure. In general, however, it must possess certain recognizable qualifications and must contribute to certain rather specific results. The effective teacher should be thoroughly acquainted with his subject matter, should possess an enthusiasm for his field, and should be deeply interested in his students. He should have a keen desire to contribute to his students' future accomplishments through the medium of his teaching, and be motivated in large part by the view that their success will represent, in part, his success and his contribution to the social scheme. Basically, the effective teacher should also be strongly motivated by a desire to improve the social body. Effective teaching must therefore create and develop strong interests in the field in which the teaching is being done; it must encourage students to accumulate a store of knowledge in the field; it must stimulate think-

ing; it must seek to influence students to build their own structure in the field, to make the material of the field their own, to see the material of the field from all possible angles, to develop a philosophical relationship to the field, to improve the field, etc. The effective teacher's accomplishments will be assisted by his faith in his students, by an atmosphere of expected performance, by the standards which he establishes, by his ability to discover the qualifications and the potentialities of his students, and by his ability to inspire them and to raise the level of their lives.

The methods and techniques used to accomplish these ends will necessarily vary with the individual instructor since he will be under compulsion to apply his own native abilities and his own personality to the task. The extent to which a given individual can use the methods found to be successful by another is questionable. In the usual case the individual's teaching techniques are apt to be unconscious, evolutionary developments, gradual adaptations found to be effective in meeting the challenge of numerous varying situations. While the same or similar methods may be used subsequently they are, again, likely to represent unconscious performances.

One effective approach to the presentation of accounting topics is a "let's look the subject over" approach. Let's not only present the one statement of principle or procedure, but let's also consider what others say about it, and let's get the student to tell us about it. In the second place consideration should be given to those factors which appear to make certain conclusions more reasonable (or more desirable) than others. Usually the measurement is set against the requirements of basic goals. The process thus involved may be indicated by the following:

Instructor: Mr. A., What is meant in accounting by the term depreciation?

Mr. A.: Depreciation refers to a decline in the value of a fixed asset resulting from the influence of such factors as wear and tear, obsolescence, shift in demand, inadequacy, accidents, diseases, etc.

Instructor: It is true that many of the fixed assets are affected by wear and tear, obsolescence, etc., but why is accounting specifically called upon to recognize these effects?

Mr. A.: The influences mentioned assist in terminating the service life of the asset. Once one of these factors exercises its full effect the asset is no longer useful.

Instructor: Granting the validity of this point, what accounting significance does it have?

Mr. A.: When an asset reaches the end of its usefulness, strictly speaking, it is no longer an asset, and should therefore be removed from the books.

Instructor: Then would you wait until the usefulness of the asset was completely terminated before taking any steps to remove it from the books?

Mr. A.: No. I would remove it piecemeal as the services are being extracted.

Instructor: How would you do this?

Mr. A.: At the acquisition of the asset I would estimate the total probable number of years in the asset's service life. I would then take a pro rata portion of the asset's cost (less any estimated scrap value) and charge it to expense each period, crediting the asset account, or, more commonly, a reserve or allowance account. The result of this procedure is that the cost of the asset is removed from the books, piecemeal year after year, over its service life. By the time that the service life is completed the whole of the cost would have been removed from the books.

Instructor: Do you believe that an accounting purpose is also served by charging the cost of the asset to expense piecemeal as the instalment services are being extracted?

Mr. A.: Yes. In the first place, it serves to reduce the figure exhibited as an asset to an amount which is believed to be the cost of the remaining services. In the second place, the process results in charging to the expense of each year the estimated cost of the services believed to have been consumed in the attempt to earn an income.

Instructor: Very good, Mr. A. You have shown that the accounting depreciation process assists the accountant in exhibiting the asset and the expense correctly. But, Mr. B, why does the accountant face a necessity to do these two things?

Mr. B.: The accounting depreciation process is

merely a recognition and a recording of the businessman's financial experience.

Instructor: What do you mean by that?

Mr. B.: Business consists of putting money into things and then subsequently recovering it through the sale of the product (if the business is successful).

Instructor: Such as buying and selling merchandise?

Mr. B.: Yes. But the process of putting money into merchandise and subsequently recovering it with a profit also requires that money be put into such things as fuel, supplies, machinery, buildings, etc.

Instructor: You mean, then, that the money which the businessman secures from the sale of his goods should be interpreted as recovering the funds that he originally invested in his merchandise and as also recovering a portion of the funds originally invested in the machinery, buildings, etc.?

Mr. B.: Yes—that's it, exactly.

Instructor: Then depreciation is the process of designating a part of the funds received as representing the recovery of funds originally invested in fixed assets?

Mr. B.: Exactly.

Instructor: But suppose that the funds received from the sale of goods do not equal the total costs of doing business?

Mr. B.: In that event the businessman fails to recover all of the funds (or the proper proportion of them) originally invested in the fixed assets and we can assume that he has suffered a loss. There really is no difference between this situation and a situation in which a man sells securities for less than he paid for them, except that in the former case we are prorating the cost.

Instructor: Such being the case, then, Mr. B, and assuming that the funds received from sales equal or exceed the total cost of doing business give me the entry in balance sheet terms that you would make to record depreciation.

Mr. B.: Balance sheet terms?

Instructor: Yes, balance sheet terms.

Mr. B.: I would credit the asset, or more specifically the allowance or reserve account, and debit surplus.

Instructor: We assumed that the business at least broke even, why then do you debit surplus? Does depreciation represent a loss?

Mr. B.: No. It could not be a loss under the assumption stated. However, I also assumed that when sales were made cash or receivables was debited and surplus credited. The debit to surplus at the time that depreciation is recognized does not represent a loss but rather the correction of an "over credited" surplus.

Instructor: Then if you are correcting an "over credited" surplus, the surplus account should not really have been credited in the first place. It was credited merely as a temporary convenience until such time as it was practical to make the true or effective credit to the asset account.

Mr. B.: That's correct.

Instructor: Then ignoring the suspense aspect of the situation the true explanation of the depreciation picture is that cash or receivables was debited and the asset credited.

Mr. B.: That's right.

Instructor: Then depreciation is really the recognition of the gradual conversion of a fixed asset into cash or its equivalent (assuming that the business at least breaks even.)

Mr. B.: That's right.

Instructor: The usual process is to credit revenue to Sales and debit depreciation to an expense account. Demonstrate that this process finally reduces to the effect of debiting cash and crediting the asset.

Mr. B.: Well, when sales are made Cash is debited and Sales credited. In this case Sales rather than Surplus is the suspense account. *Second,* Depreciation Expense is debited and the asset, or a reserve account, credited. *Third,* the closing entries will in effect wipe out both the Sales account and the Depreciation Expense account. The net effect will be to leave the depreciation entry a debit to Cash and a credit to the Asset account.

Instructor: Very good, Mr. B. Mr. C., what happens to the cash which represents the partial liquidation of the fixed asset; that is, the cash which is equivalent to the estimated depreciation?

Mr. C.: Oh, it becomes free cash the same as any other cash. It can therefore be used to purchase merchandise or other assets, to pay wages or other expenses, or to retire liabilities. It hasn't any strings tied to it.

Instructor: Then, you don't have to save it to replace the asset being depreciated?

Mr. C.: No. Not unless you believe such a step to be desirable.

Instructor: Can you use it to pay dividends?

Mr. C.: That's a good question, Sir. If the business is profitable the portion of the total cash received from the sales which the business will have left after the expenses have been paid should be equal at least to the sum of the profit and the depreciation (that is, provided none of it was used to purchase other assets, retire lia-

bilities, etc.). Only an amount equal to the profit portion, however, will be credited to Surplus. Presumably, therefore, only the portion of the cash equal to the surplus is available for dividends. The cash, equal to the depreciation, will be retained in the business. Apparently, the answer to your question is No.

Instructor: Your answer is subject to certain qualifications, but in general it is acceptable. Suppose, however, that the business was one which dealt in assets subject to depletion, would the cash then be available for dividends?

Mr. C.: Yes, liquidation dividends.

Instructor: Why the difference in the two situations?

Mr. C.: Legally, the business which deals in assets subject to depletion is a limited-life affair and it is possible to assume that it would be justified in returning the capital to its stockholders over that limited period as the assets are being depleted and depreciated. The ordinary business, however, is a going concern. The liquidation act is not as freely taken in such a business. It is usually assumed, therefore, that capital will be maintained and not decreased as the assets are depreciated.

Instructor: Assuming, again, that the business is successful, how does the depreciation process serve to maintain the asset values that back up capital?

Mr. C.: As I stated before, the cash representing depreciation is not available for dividends; it is retained in the business. Actually, depreciation means that we have given up, sacrificed, a portion of a fixed asset in conducting the business. If capital is to be a meaningful figure, it must be backed by assets, one hundred cents on the dollar. Since we give up a portion of the fixed asset in conducting the business, we retain the cash in the business as a substitute for the portion of the fixed asset given up. So far as capital is concerned, then, we are "even Steven." All that has happened is that the nature of the assets backing up the capital has changed, cash replaces fixed asset.

Instructor: Then you really have to keep the retained cash in cash form?

Mr. C.: No. My statement was inaccurate. As I stated before, it can be used to buy other assets, retire liabilities, etc., but the first step in substitution is to substitute cash or receivables for the depreciated asset portion.

Instructor: Can the cash be used to pay dividends?

Mr. C.: No. I think we've covered that point.

Instructor: Can you illustrate this maintenance of capital aspect of the depreciation process?

Mr. C.: I guess so. If we assume a business with only a truck as an asset and no liabilities, then the capital would be an equivalent amount. If we assume that the proprietor does not believe in depreciation and that at the end of each year he takes out of the business the amount which he designates as profit, he would wake up at the end of a given period of years with no truck. Some day it would fall apart. With no truck there would be no asset, and with no asset the capital figure would be meaningless. Thus, not only did he misstate his profits over the years but he liquidated his business by withdrawing the so-called profit. However, if he had believed in depreciation and had recognized it, his profit figure would have been smaller each year and he would have taken a correspondingly smaller amount out of the business. When the truck was entirely worn out there would have been retained in the business, assuming that it had been successful, an amount equal to the original cost of the truck. Thus, although the truck had reached the end of its life, it would have been replaced by an equivalent amount of other assets. The capital would therefore still be a correct figure.

Instructor: Would these new assets necessarily be in the form of cash?

Mr. C: Not necessarily.

Instructor: Very good, Mr. C. You seem to understand the fundamentals of the depreciation process. I believe that we have now shown that the depreciation process can be said to fulfill an asset function, an expense function, and a maintenance of capital function, and that basically it represents a financial experience.

Mr. D.: All very complex.

Instructor: No, not complex; it merely sounds that way. Actually, this probably represents the first time that you have really boxed the fundamental problem. Think about it and I am sure that you will find it both clear and simple!

TEACHING A COURSE IN INTERNAL AUDITING

VICTOR Z. BRINK
West, Flint and Company

In recent years there has been a rather strong upsurge of interest in internal auditing. The growth in size of modern

corporate enterprise has, of course, created the need for internal auditing and, accordingly, much more attention has been given to this special field by all interested parties. In 1941, for example, the Institute of Internal Auditors was formed. This organization now includes eighteen chapters and some 1,250 members. Many corporations have in recent years established internal auditing departments and other corporations have expanded their programs. Reference to the last two volumes of the *Accountants' Index* is convincing evidence of the great increase in the literature on the subject. Several educational institutions in the last year or two have offered courses in the field. The two instances known to the writer were at the University of Miami, and the University of Toronto. In view of these precedents the writer undertook recently to organize such a course at Columbia University.

The course as set up at Columbia is a three-point credit, one-semester course. It is open only to accounting students who have had the regular courses in first and second year accounting, and, except for certain special cases, only to persons who have had the basic course in general auditing. The course may be taken for either undergraduate or graduate credit.

In planning the course the objective was to accomplish two things. The first was to provide a course in internal auditing which would meet regular academic standards. The second objective was to explore fully the possibilities of integrating business practice with the regular course program.

In attempting to accomplish the first objective the writer used his own text, *Internal Auditing*. There were thirty classroom hours and eighteen of these, or sixty per cent of the total, were devoted to the discussion of the text assignments. The other twelve hours, or forty per cent of the total, were used for the presentation of illustrative case material. The latter material was presented by twelve men who were in charge of internal auditing in various large corporations in the New York area. In each case when a guest speaker appeared, he had been informed of the topic under discussion, and his material was directed to illustrating the application in practice of that part of internal auditing. The actual program of the fifteen two-hour meetings was as shown in the table on the following page.

One of the most difficult features of the course was to provide adequate outside problem or research work. This difficulty was accentuated by the fact that of the class of 38 students, approximately one-half were full-time day students and the other half were employed during the day with private corporations or with public accounting firms. In the case of the regular day students, arrangements were made with companies in and about New York to permit each student to make a field study of his company's internal auditing program. This field study involved three to five days and was directed in the case of each company (1) to determining the organizational set up for internal auditing (2) to the review of all available manuals and bulletins of instruction, and (3) by the review of reports and discussions with the auditor or his assistants to review and appraise the results being obtained. The student then prepared a report which the writer reviewed, after which it was turned over to the cooperating company.

The employed students were asked to prepare a report covering the analysis and appraisal of some phase of their own company's procedures or, in the case of public accounting men, internal control problems encountered in their practice. In several special cases, as a last resort, the additional work had to consist of the preparation of a report covering the presentations of the guest lecturers.

In general, the results achieved seem to

INTERNAL AUDITING

COURSE PROGRAM

No	*Text[1] Assignment*	*Subject for Discussion*	*Guest Lecturer for Second Hour*
1	Chap. 1	Introductory-Statement of the Problem	—
2	Chap. 2	Services of Internal Auditing	—
3	Chap. 3	Organization and Operation of an Internal Auditing Department	William H. Garbade, Assistant Treasurer, Shell Oil Company
4	Chap. 4 Chap. 5 (pp. 93–102)	Internal Check and Internal Control, and Preliminary	John B. Thurston, Partner, Thurston & Co.
5	Chap. 5 (pp. 103–130)	Cash and Related Procedures	David Mathias, Auditor, Bankers Trust Co.
6	Chap. 6 (pp. 131–158)	Receivables and Related Procedures	Max A. Kenyon, Asst. Comptroller, Colgate-Palmolive Peet Co.
7	Chap. 6 (pp. 158–164)	Investments and Related Procedures	Joseph J. Clair, Comptroller, Metropolitan Life Ins. Co.
8	Chap. 7	Inventories and Related Procedures	Phillips C. Salman, Asst. Comptroller, Socony-Vacuum Oil Co., Inc.
9	Chap. 8 (pp. 202–223) Chap. 8 (pp. 223–240)	Fixed Assets and Related Procedures Other Assets and Related Procedures	Herbert C. M. Cobb, Auditor, Worthington Pump & Machinery Corporation
10	Chap. 9 Chap. 10 (pp. 266–285)	Payables and Related Procedures, Accrued Liabilities, Payroll and Related Procedures	Bradford Cadmus, Managing Director, The Institute of Internal Auditors, Inc.[2]
11	Chap. 10 (pp. 286–294) Chap. 11 (pp. 295–303) Chap. 11 (pp. 304–314) Chap. 11 (pp. 315–331)	Other Liabilities and Related Procedures Ownership Equities and Related Procedures Income and Related Procedures Expense and Related Procedures	Arthur E. Hald, Auditor, Consolidated Edison Company of New York, Inc.
12	Chaps. 12, 13	Other Regular and Special Activities	Curtis T. Atkisson, Financial Staff, Ebasco Services, Inc.
13	Chap. 14	Working Papers and Reports	Robert B. Milne, Auditor, Columbia Engineering Corporation
14	Chap. 16	Coordination with Outside Auditor	Weston Rankin, Principal, Price, Waterhouse & Co.
15	Chaps. 15, 17	Conclusions	—

[1] *Internal Auditing* by Brink, Ronald Press, 1941.
[2] Prior to January 1, 1947, Assistant Comptroller of Standard Brands, Inc.

have been satisfactory. The students were intensely interested in the practice material which was presented, especially when it was integrated into a systematic program. They seemed also to appreciate the new insight into the real nature of internal auditing and its potentialities for management service. The guest lecturers have also agreed to write up their respective presentations in order that in the near future they can be made available to other institutions for use in connection with a course in internal auditing.

It should be mentioned also that the Institute of Internal Auditors is presently developing a statement of the objectives of internal auditing and the responsibilities of the internal auditor. This statement is scheduled for release at the Institute's annual conference in October. The release of this statement will, it is believed, provide a more authoritative basis for defining the work of the internal auditor and should be useful in connection with any course in internal auditing.

PROFESSIONAL EXAMINATIONS

A Department for Students of Accounting

HENRY T. CHAMBERLAIN

THE FOLLOWING problems were prepared by the Board of Examiners of the American Institute of Accountants and were presented as the second half of the C. P. A. examination in accounting practice on May 15, 1947. The candidates were allowed four and a half hours to solve problem 1 and either problem 2 or problem 3. Problem 1 was given a weight of 30 points and 20 points was assigned to either problem 2 or problem 3.

A suggested time schedule is given below:

Problem 1—135 minutes
Problem 2— 60 minutes
Problem 3— 75 minutes

No. 1

From the following information, prepare a balance-sheet as at December 31, 1944, in accordance with the authorization of board of directors referred to below. Your adjustments should be clearly keyed by letters or numbers on your working tiral balance.

The Construction Corporation is engaged in a variety of construction work under contracts, the collections on which are made on the basis of engineering and architects' estimates as to stage of completion. Customers usually retain a percentage of the amount of each estimate pending completion of the contract.

Gross profit on contracts has been shown in the books and financial statements in the year of completion. Since experience has shown the loss on contracts to be negligible, the board of directors authorized the restatement of the accounts on the basis of accruing income in proportion to completion of contracts during 1944.

A trial balance of the general ledger of Construction Corporation at December 31, 1944, is as follows:

	Dr.	*Cr.*
Cash	$ 210,100	$
Imprest work funds	10,000	
Earned receivables—billings based on engineers' and architects' certificates	315,000	
Retained percentages receivable	110,000	
Postwar excess-profits tax refund credit	32,000	
Advance purchases	220,000	
Prepaid insurance	31,000	
Investment in subsidiary company (Jones Sand Co. Inc.)	100,000	
Advances to subsidiary company (Jones Sand Co. Inc.)	48,000	
Land	60,000	
Buildings	240,000	
Machinery and equipment	1,375,000	
Reserve for depreciation—buildings, machinery, and equipment		700,000
Notes payable to banks		40,000
Accounts payable—trade		290,000
Estimated Federal income and excess-profits taxes payable		150,000
Accrued taxes—other than Federal taxes on income		25,000
Accrued expenses		22,500
Purchase money mortgages payable June 30, 1946		200,000
Common capital stock		125,000
Capital surplus		275,000
Earned surplus, January 1, 1944		318,600
Contract sales—billed revenues		3,370,000
Cost of contracts in progress	612,000	
Cost of contracts completed	1,828,000	
Administrative and general expenses	175,000	
Provision for Federal income taxes—1944	150,000	
	$5,516,100	$5,516,100

Relevant data:

1. Summary of construction in progress:

Contracts	Total Contract Price	January 1, 1944 Balance		1944	
		% of Completion	Cost	% of Completion	Cost
A	$1,200,000	85	$814,000	15	$119,000
B	1,300,000	40	305,000	14	107,000
C	900,000		—	35	200,000
D	500,000		—	100	375,000
E	450,000		—	100	340,000
F	240,000		—	100	180,000

2. The balance of $3,370,000 in "contract sales-billed revenues" account represents (a) the total of completed contracts billed in 1944 plus (b) incompleted contracts billed, as follows:

Contract B	$675,000
Contract C	305,000
	$980,000

3. In its federal income-tax returns, the company reports contract gross profit on the basis of completed contracts. An estimated federal income-tax liability of $150,000 had been provided for in the accounts during 1944. The effective tax rate for 1943, 1944, and 1945 may be considered as being 40% of net income (disregard interest on any prior years' income taxes and the applicability of any other sections or provisions of the Internal Revenue Code).

4. Construction Corp., is using equipment of its wholly owned subsidiary, the Jones Sand Co., Inc., on Contract C, and in lieu of rent is allowing that company 50% of the gross profit on the contract, after deducting such rental charge. Such allowance is not shown in the accounts.

5. The corporation made advance payments for equipment; these appear as charges in the advance purchases account as follows:

Cash advanced for machines not received	$ 40,000
Cash advanced for machines received in December, 1944, and in yard	70,000
Credits to trade accounts payable for machines completed, billed, and held by vendors—not paid for	110,000
	$220,000

No. 2

The Board of Aldermen of the City of Fulton determine to pave First Street at an estimated cost of $100,000 and take necessary legislative action to initiate the project. The charter of the City requires that the cost of such projects be shared 60% by the City at large and 40% by the district benefited. Bids are obtained and the contract for the work is awarded the ABC Construction Company for $95,000.

The accounts of the City are maintained on a full accrual basis with provision for encumbering appropriations and with assessment and other characteristic groups of accounts separated. The City has a Revolving Fund of $125,000 which is used to finance uncollected assessments receivable and projects in process pending completion and assessment. This fund at present is invested in assessments receivable and other projects in process aggregating $75,000, and consequently $50,000 must be borrowed temporarily on certificates of indebtedness to finance the First Street project. Ten per cent of the front footage of property in the district benefited is city owned, half of that amount having been acquired through foreclosure of tax liens and half representing the front footage of public buildings and facilities. Street improvement bonds, which will be general obligations of the City, will be sold to finance the City's share of the cost of the improvement. For the purpose of section (a) this problem you may disregard any question of premium or interest on the

temporary certificates of indebtedness and on the bonds, also ignore the fact that property improvement assessments are usually payable in installments.

(a) Prepare a series of entries in journal entry form, with complete explanations accompanying each, recording the various actions and financial transactions relating to this undertaking as they might appear in the assessment fund accounts of the city.

The Assessment Roll submitted to the Board of Aldermen for confirmation provided for the payment of the assessment against respective properties in five equal installments, and was confirmed by the Board, as submitted, without change.

(b) You are required to prepare a draft of an assessment roll, making thereon two specimen entries for two separate property owners with respect to the first and second installments.

No. 3

Submit pertinent working papers, a reconciliation of all reciprocal accounts of the three companies and an accounting of the differences between the original and corrected net income figures in summary form for use in preparing the income-tax returns of X and Y.

X is a processor of steel parts for machines, trading as the X Machine Company. Y assembles machine parts and trades as the Y Assembly Company.

On January 1, 1945, X and Y decided to form a partnership, to be known as the General Manufacturing Company. It was contemplated that each partner would continue his own business, dealing both with the partnership and with outsiders. The profit-and-loss ratio was X 40% and Y 60%.

Statements of profit and loss follow. No audit was made of the accounts before preparation of the statements (next column).

	X Machine Co.	*Y Assembly Co.*	*General Mfg. Co.*
Sales	$265,000	$540,000	$870,000
Cost of sales	154,000	372,000	525,000
Gross profit	$111,000	$168,000	$345,000
Expenses	78,000	93,000	210,000
Net profit from operation	$ 33,000	$ 75,000	$135,000
Gain on sale of business property	3,500		3,000
Loan by Y, deemed worthless on account of adjudication in bankruptcy		2.000	
	$ 36,500	$ 73,000	$138,000

An audit of the accounts and records of the three companies at December 31, 1945, disclosed the following:

Included in cost of sales of General Manufacturing Company were purchases from the X Machine Company of $135,000. Sales to General Manufacturing Company on the books of X Machine Company were $145,000. Analysis of the discrepancy discloses that X Machine Company had billed General Manufacturing Company for $8,000 which General Manufacturing Company claimed was fictitious. In addition, General Manufacturing Company took a credit of $2,000 for defective merchandise, not recorded by X Machine Company.

Y Assembly Company disbursed substantial sums on behalf of General Manufacturing Company during the first three months of the latter's existence. An "Advances" account was used by both companies.

Analysis of the "Advances" account follows:

	Charges to Gen. Mfg. Co. On books of Y Assembly Co.	Credits to Y Assembly Co On books of Gen. Mfg. Co.
Sale of Machine for Y Co. by Gen. Mfg. Co.	$ 3,000	
Insurance	2,000	$ 2,000
Legal expenses	200	
Freight	430	
Advertising	125	
Machinery		25,000
Supplies	10,050	
Payroll	11,190	
	$26,995	$27,000

Y Assembly Company also purchased parts from X Machine Company and sold them to General Manufacturing Company.

The books of the three companies involved showed the following entries in connection with these transactions:

(1) On the books of X Machine Company		
Y Assembly Company.....	$55,000	
Sales..................		$55,000
(2) On the books of Y Assembly Company		
Purchases................	$40,000	
X Machine Company....		$40,000
General Manufacturing Company................	$85,000	
Sales.................		$85,000
(3) On the books of Gen'l. Manufacturing Company		
Purchases................	$65,000	
Y Assembly Company...		$65,000

X and Y were unable to reconcile their differences and a Special Master in Chancery was appointed in January, 1946, to find an equitable reconciliation.

His findings were as follows:

(a) X Machine Company's bill to General Manufacturing Company of $8,000 was entirely unsupported and therefore disallowed.

(b) General Manufacturing Company was entitled to $1,000 credit for defective merchandise.

(c) Expenses disbursed by Y Assembly Company on behalf of General Manufacturing Company were allowed except for the following:
1. Legal expense to be borne equally
2. Advertising allowed in amount of $25 only
3. Payroll overstated on Y Assembly Company's books by $325

(d) The machine recorded on the books of General Manufacturing Company actually was owned by Y Assembly Company. General Manufacturing Company has deducted $625 depreciation for the three-month period. Y Assembly Company had also deducted $625 depreciation. This machine was used by General Manufacturing Company from date of acquisition on July 1, 1945 to October 1, 1945 when it was sold by General Manufacturing Company for $27,375, or $3,000 in excess of adjusted book value. Y Assembly Company charged General Manufacturing Company with $3,000 representing actual profit of $2,375, plus rental charges of $625. This was allowed. The $3,000 was credited to Cost of Sales on Y Assembly Company's books.

(e) As to sales by X Machine Company to Y Assembly Company and by Y Assembly Company to General Manufacturing Company, X Machine Company should have charged Y Assembly Company $50,000 and Y Assembly Company should have charged General Manufacturing Company $70,000.

Solution to Problem 1

(1)

Contract sales-billed revenues		$1,540,000.00	
Cost of contracts computed			$814,000.00
Cost of contracts in progress			305,000.00
Earned surplus—January 1, 1944 (Profit and Loss)			421,000.00
To adjust accounts for percentages of completion on contracts A and B applicable to prior years: January 1, 1944:			
Contract A—85% of $1,200,000	$1,020,000.00		
Contract B—40% of 1,300,000	520,000.00		
	$1,540,000.00		

(2)

Earned surplus, January 1, 1944 (Profit and Loss)	$ 168,400.00	
Estimated Federal income and excess profits tax payable		$168,400.00
To set up liability for taxes payable on income of prior year (40% of $421,000.00)		

(3)

Earned receivables—unbilled	$ 37,000.00	
Contract sales—unbilled revenues		$ 37,000.00
To record percentage of completion unbilled		

	Contract B	*Contract C*
Contract price	$1,300,000.00	$900,000.00
Percentage completed	54	35
Percentage of contract price	$ 702,000.00	$315,000.00
Amount billed	675,000.00	305,000.00
Unbilled amount	$ 27,000.00	$ 10,000.00

(4)

Cost of contracts in progress		$ 38,333.00	
Advances to subsidiary			$ 38,333.00
To set up rental on contract C:			
Amount completed	$315,000.00		
Costs (other than rental)	200,000.00		
Remainder (equal to 150% of gross profit)	$115,000.00		
Rental (⅓ of $115,000.00)	38,333.00		
	$ 76,667.00		

(5)

Machinery and equipment	$ 70,000.00	
Advance Purchases		$ 70,000.00
To record machines received in December		

(6)

Estimated Federal income and excess profits tax payable	$ 16,933.00	
Provision for Federal income		$ 16,933.00
To adjust estimated taxes for 1944 computed on the basis of percentage of completion:		
Contract sales		$1,867,000.00
Cost of contracts		$1,359,333.00
Administrative and general expense		175,000.00
		$1,534,333.00
Net income, before Federal taxes		$ 332,667.00
Provision for Federal taxes		$ 150,000.00
Revised provision (40% of $332,667.00)		133,067.00
Adjustment		$ 16,933.00

NOTE: The problem states that the company reports contract gross profit on the basis of completed contracts in its federal tax returns. The above solution changed the accounts to accrue income on a percentage of completion basis. The total tax liability on this basis is $301,467.00 however the amount payable in 1945 on work completed in 1944 is $154,800.00 as computed below:

Contract sales—billed	$3,370.000.00
Less billings on uncompleted contracts	980,000.00
Completed contract sales	$2,390,000.00
Cost of completed contracts	$1,828,000.00
Administrative and general expense	175,000.00
	$2,003,000.00
Net income, before Federal taxes	$ 387,000.00
Federal taxes—40% of $387,000.00	$ 154,800.00

Construction Corporation
Balance Sheet
December 31, 1944

Assets

Current Assets			
Cash on hand and in bank		$220,100.00	
Accounts receivable:			
Contracts billed	$ 315,000.00		
Retained percentages	110,000.00		
Contracts not billed	37,000.00	462,000.00	$ 682,100.00
Prepaid insurance			31,000.00
Post-war excess profits tax refund			32,000.00
Investment in subsidiary company			
Capital stock		$100,000.00	
Advances		9,667.00	$ 109,667.00
Fixed Assets			
Land		$ 60,000.00	
Buildings	$ 240,000.00		
Machinery and equipment	1,445,000.00		
	$1,685,000.00		
Less reserve for depreciation	700,000.00	985,000.00	
Advances on purchase of equipment		150,000.00	1,195,000.00
			$2,049,767.00

Liabilities

Current Liabilities		
Notes payable to banks	$ 40,000.00	
Accounts payable-trade	290,000.00	
Federal taxes payable in 1945	154,800.00	
Other accrued taxes	25,000.00	
Accrued expenses	22,500.00	$ 532,300.00
Federal taxes due after 1945—estimated		$ 146,667.00
Purchase money mortgage due June 30, 1946		$ 200,000.00
Capital stock and surplus		
Capital stock	$125,000.00	
Capital surplus	275,000.00	
Earned surplus	770,800.00	1,170,800.00
		$2,049,767.00

Construction Corporation
Working Papers
December 31, 1944

	Trial Balance Dr.	Trial Balance Cr.	Adjustments Dr.	Adjustments Cr.	Profit and Loss Dr.	Profit and Loss Cr.	Balance Sheet Dr.	Balance Sheet Cr.
Cash	$ 210,100	$ —	$ —	$ —	$ —	$ —	$ 210,100	$ —
Imprest work funds	10,000	—	—	—	—	—	10,000	—
Earned receivables—billed	315,000	—	—	—	—	—	315,000	—
Retained percentages receivable	110,000	—	—	—	—	—	110,000	—
Post-war excess profits tax refund credit	32,000	—	—	—	—	—	32,000	—
Advance purchases	220,000	—	—	(5) $ 70,000	—	—	150,000	—
Prepaid insurance	31,000	—	—	—	—	—	31,000	—
Investment in subsidiary company	100,000	—	—	—	—	—	100,000	—
Advances to subsidiary company	48,000	—	—	(4) 38,333	—	—	9,667	—
Land	60,000	—	—	—	—	—	60,000	—
Buildings	240,000	—	—	—	—	—	240,000	—
Machinery and equipment	1,375,000	—	(5) $ 70,000	—	—	—	1,445,000	—
Reserve for depreciation-buildings and equipment	—	$ 700,000	—	—	—	—	—	$ 700,000
Notes payable to banks	—	40,000	—	—	—	—	—	40,000
Accounts payable-trade	—	290,000	—	—	—	—	—	290,000
Estimated federal income and excess profits taxes	—	150,000	(6) 16,933	(2) 168,400	—	—	—	301,467
Accrued taxes—other than federal taxes	—	25,000	—	—	—	—	—	25,000
Accrued expenses	—	22,500	—	—	—	—	—	22,500
Purchase money mortgages—due June 30, 1946	—	200,000	—	—	—	—	—	200,000
Common capital stock	—	125,000	—	—	—	—	—	125,000
Capital surplus	—	275,000	—	—	—	—	—	275,000
Earned surplus, January 1, 1944	—	318,600	(2) 168,400	(1) 421,000	—	—	—	571,200
Contract sales—billed revenues	—	3,370,000	(1) 1,540,000	—	—	$1,830,000	—	—
Cost of contracts in progress	612,000	—	(4) 38,333	(1) 305,000	$ 345,333	—	—	—
Cost of contracts completed	1,828,000	—	—	(1) 814,000	1,014,000	—	—	—
Administrative and general expenses	175,000	—	—	—	175,000	—	—	—
Provision for federal income taxes—1944	150,000	—	—	(6) 16,933	133,067	—	—	—
	$5,516,100	$5,516,100	—	—	—	—	—	—
Earned receivables—unbilled	—	—	(3) 37,000	—	—	—	37,000	—
Contract sales—unbilled revenues	—	—	—	(3) 37,000	—	37,000	—	—
					$1,667,400	$1,867,000	—	—
Net income					199,600	—	—	199,600
					$1,867,000	$1.867,000	$2,749,767	$2,749,767

Solution to Problem 2

City of Fulton
Assessment Fund
(a) Journal Entries

(1)			
Improvements authorized—First Street paving		$100,000.00	
Reserve for authorized expenditures			$100,000.00
To record authorization of paving of First Street per action of Board of Aldermen on (date)			
(2)			
Encumbrances		$ 95,000.00	
Reserve for Encumbrances			$ 95,000.00
To record contract awarded to ABC Construction Company for paving of First Street			
(3)			
Assessments receivable		$ 36,100.00	
City of Fulton's share of cost		58,900.00	
Improvements authorized			$ 95,000.00
To record levy of assessments and City of Fulton's share of cost as follows:			
Assessments receivable:			
Private property owners (36% of $95,000)	$34,200.00		
Foreclosed property (2% of $95,000)	1,900.00		
Total	$36,100.00		
City of Fulton's share of cost:			
City at large (60% of $95,000)	$57,000.00		
Property used by City (2% of $95,000)	1,900.00		
Total	$58,900.00		
(4)			
Cash for construction		$ 95,000.00	
Construction notes payable			$ 50,000.00
Due to Revolving fund			45,000.00
To record cash received from temporary certificates of indebtedness and loan from Revolving fund			
(5)			
Cash for notes, interest and inter-fund loans		$ 58,900.00	
City of Fulton's share of cost			$ 58,900.00
To record receipt of proceeds of Street Improvement bonds from General Fund			
(6)			
Construction notes payable		$ 50,000.00	
Cash for notes, interest and inter-fund loans			$ 50,000.00
To record payment of temporary certificates of indebtedness			
NOTE: No rate of interest or time of payment is given in problem therefore no payment of interest can be shown.			
(7)			
Construction expenditures		$ 95,000.00	
Reserve for encumbrances		95,000.00	
Encumbrances			$ 95,000.00
Cash for construction			95,000.00
To reverse entry No. 2 and record payment to ABC Construction Company upon completion of contract			
(8)			
Due to Revolving fund		$ 45,000.00	
Cash for notes, interest and inter-fund loans			$ 8,900.00
Assessments receivable-assigned			36,100.00
To record transfer of cash and assignment of assessments to Revolving fund			
(9)			
Assessments receivable-assigned		$ 36,100.00	
Assessments receivable			$ 36,100.00
To record collection of assigned assessments by Revolving fund			
(10)			
Reserve for authorized expenditures		$ 95,000.00	
Construction expenditures			$ 95,000.00
To close expenditures into the reserve account			
(11)			
Reserve for authorized expenditures		$ 5,000.00	
Improvements authorized—First Street paving			$ 5,000.00
To close unencumbered balance of the reserve for authorized expenditures			

(b) City of Fulton
Special Assessment Roll
Paving First Street

Owner	Legal Description	Total Assessment	First Installment	Collections			Second Installment	Collections		
				Date	Principal	Interest		Date	Principal	Interest
R. V. Allen 13 E. 41st St.	Lot 1 in Block 2	$200.00	$40.00	3-1-46	$40.00	$12.00	$40.00	3-1-47	$40.00	$ 9.60
L. B. Wilson 15 E. 1st St.	Lot 2 in Block 3	400.00	80.00	3-1-46	80.00	24.00	80.00	3-1-47	80.00	19.20

Solution to Problem 3

Books of X Machine Company

	Dr.	Cr.
Due from General Manufacturing Company:		
Balance, per books	$145,000.00	
Disallowed billing		$ 8,000.00
Credit for defective merchandise		1,000.00
Balance due	$136,000.00	
Due from Y Assembly Company:		
Balance, per books	$ 55,000.00	
Credit for overcharge		$ 5,000.00
Balance due	$ 50,000.00	
Net income		
Balance, per books		$36,500.00
Disallowed billing to General Mfg. Co.	$ 8,000.00	
Allowance to General Mfg. Co. for defective goods	1,000.00	
Overcharge to Y Assembly Company	5,000.00	
Net income, after adjustment (X Machine Co.)		$22,500.00
Share of partnership profits (General Mfg. Co.)		43,012.00
Net income of X		$65,512.00

Books of Y Assembly Company

	Dr.	Cr.
Advances to General Manufacturing Company:		
Balance, per books	$26,995.00	
Legal expense disallowed		$ 100.00
Advertising expense disallowed		100.00
Adjustment of overstated payroll liability		325.00
Cost of machinery sold by General	25,000.00	
	$51,995.00	525.00
Balance due	$51,470.00	
Due from General Manufacturing Company:		
Balance, per books	$85,000.00	
Adjustment of selling price of goods		$ 15,000.00
Balance due	$70,000.00	
Due to X Machine Company:		
Balance, per books		$ 40,000.00
Adjustment of cost of goods		10,000.00
Balance due		$ 50,000.00

Net income:		
Balance, per books		$ 73,000.00
Legal expense	$ 100.00	
Advertising	100.00	
Correction of credit to cost of sales	3,000.00	
Rent—machinery		625.00
Profit on sale of machinery		3,000.00
Adjustment of cost of goods purchased from X	10,000.00	
Adjustment of selling price of goods to General	15,000.00	
	$28,200.00	$ 76,625.00
Net income, after adjustment (Y Machine Co.)		$ 48,425.00
Share of partnership profits (General Mfg. Co.)		64,518.00
Net income of Y		$112,943.00

NOTE: In this solution it is assumed that the overstated payroll resulted in an adjustment on Y's books reducing both its claims against General and the payroll liability account. If the overstated payroll was the result of an incorrect allocation of expense between Y and General, then the adjustment on Y's books would be a charge to cost of sales and a credit to General.

Books of General Manufacturing Company

	Dr.	*Cr.*
Advances from Y Assembly Company:		
Balance, per books		$ 27,000.00
Legal expense		100.00
Freight		430.00
Advertising		25.00
Supplies		10,050.00
Labor		10,865.00
Profit on sale of machinery		3,000.00
Balance due		$ 51,470.00
Due to Y Assembly Company:		
Balance, per books		$ 65,000.00
Adjustment of cost of goods		5,000.00
Balance due		$ 70,000.00
Due to X Machine Company:		
Balance		$135,000.00
Adjustment for defective goods		1,000.00
Balance due		$136,000.00
Net income:		
Balance, per books		$138,000.00
Adjustment for defective goods purchased from X	$ 1,000.00	
Legal expense	100.00	
Freight	430.00	
Advertising	25.00	
Supplies	10,050.00	
Labor	10,865.00	
Correction of profit on sale of machinery	3,000.00	
Adjustment of cost of goods purchased from Y	5,000.00	
	$30,470.00	$138,000.00
Net income, after adjustment		$107,530.00
X's share		$ 43,021.00
Y's share		64,518.00
		$107,530.00

ASSOCIATION NOTES

Frank P. Smith

Alabama

University of Alabama:

Edward W. Brennan, Shelton A. Mador and William C. Tuthill have been appointed instructors, Franklyn H. Sweet has been appointed assistant professor, and W. Paul Thomas has been appointed associate professor of accounting.

George Lafferty has prepared a text entitled *An Introduction to Governmental Accounting for State Employees* which is being used by the Departments of Revenue of Alabama and Louisiana.

Chester H. Knight is serving as Secretary-Treasurer of the Alabama Society of Certified Public Accountants and as a member of the State Board of Public Accountancy.

Ralph C. Russell has returned to his teaching duties after a year's leave of absence at the University of New Mexico.

William H. Whitney is serving as Director of the Internship Program recently organized by the Department.

California

University of California, at Berkeley:

Leonard A. Doyle has returned to his teaching duties after serving as Director of Economic Research with Permanete Metals Corporation.

Maurice Moonitz, formerly with Arthur Andersen & Co., has been appointed associate professor of accounting.

Charles C. Staehling is on sabbatical leave during the fall semester.

Colorado

University of Colorado:

Hermann I. Arenson is on leave of absence and is serving as Chief Accountant of the State of Colorado during the revision of the State's accounting procedures.

Charles Lawrence has successfully completed the CPA examination of the State of Colorado.

District of Columbia

Catholic University of America:

Rev. Dumas L. McCleary has been appointed as instructor. He is publishing a volume entitled *Uniform Accounting Systems for Parishes*, through the Catholic University of America Press.

Connecticut

University of Connecticut:

Harry D. Kerrigan, formerly of Northwestern University, has been appointed associate professor of accounting. He served as a member of the faculty of the University of California, at Los Angeles, during the summer session of 1947.

Georgia

Emory University:

Everett R. Bollinger, Jr., has been appointed instructor of accounting.

L. E. Campbell has been reelected as Secretary of the Georgia Society of Certified Public Accountants.

Iowa

Iowa State College:

B. C. Lemke has recently received the Ph.D. degree from the University of Minnesota and a CPA certificate in the State of Iowa.

Louisiana

Louisiana Polytechnic Institute:

Leo Herbert, formerly of Brigham Young University, has been appointed Head of the Commerce Department.

Maryland

Johns Hopkins University:

James A. Leedy has been appointed instructor of accounting.

University of Maryland:

John A. Daiker, Jean F. Messer, James I. Mills, and Maynard B. Woodbury have been appointed instructors of accounting.

S. M. Wedeberg's *Principles of Accounting*, and a related practice set prepared by C. W. Cissel, are in process of publication by Huff Duplicating Co.

Massachusetts

Boston University:

Francis E. Moore has been appointed Chairman of the Education Committee of the Massachusetts Society of Certified Public Accountants.

Holy Cross College:

Edward Peragallo served as a member of the faculty of the Graduate School of Social Science of

the Catholic University of America during the 1947 summer session.

Michigan

University of Michigan:

Leo A. Schmidt, formerly of the Harvard Graduate School of Business Administration, has been appointed associate professor of accounting.

Herbert F. Taggart served as a member of the faculty of the University of California, at Berkeley, during the 1947 summer session.

Minnesota

University of Minnesota:

Carl L. Nelson, formerly of the University of Nebraska, has been appointed associate professor of accounting.

John Wheeler has been appointed assistant professor of accounting.

E. A. Heilman served as a member of the faculty of the University of California, at Los Angeles, during the 1947 summer session.

Missouri

University of Missouri:

Keith E. Davis has resigned to enter public accounting practice and Paul D. Hickman has resigned to accept a commission in the U. S. Army.

Joseph A. Silvoso has been appointed instructor of accounting.

Nevada

University of Nevada:

Leonard A. Chadwick served as a member of the faculty of the University of California, at Berkeley, during the summer session of 1947.

New Mexico

University of New Mexico:

John Dunbar, formerly of the Bureau of Internal Revenue, and William Harmeyer, formerly of Highlands University, have been appointed assistant professors of accounting.

Richard E. Strahlem has returned to his teaching duties from a year's leave as professor of accounting at the University of Miami. He is publishing, in collaboration with C. W. Beese of Purdue University, a revision of the volume entitled *Cost Finding*, originally published by Dexter S. Kimball of Cornell. This volume will be published as a part of the Alexander Hamilton Institute's "Modern Business Series."

The University has recently created a separate College of Business Administration. Vernon G. Sorrel is serving as Dean of the College.

New York

University of Buffalo:

Benjamin A. Enloe, Manager of the Buffalo Office of Price, Waterhouse & Co., is serving as professorial lecturer in accounting.

Harold M. Somers has been appointed Dean of the School of Business Administration, succeeding Ralph C. Epstein who continues as Head of the Department of Economics.

William P. Weyer, formerly with Price, Waterhouse & Co., has been appointed assistant professor of accounting.

Rufus Wixon, formerly of the University of Michigan, has been appointed professor of accounting and Head of the Department of Accounting.

University of Rochester:

Harold W. Scott has been appointed instructor of accounting.

Frank P. Smith has been promoted to the rank of professor of accounting. He served as a member of the faculty of the University of California, at Berkeley, during the summer session of 1947.

Wells College:

Raymond de Roover served as a member of the faculty of the University of California, at Berkeley, during the summer session of 1947.

Ohio

Bowling Green State University:

L. J. Benninger served as a member of the faculty of the University of Missouri during the summer session of 1947.

Cleveland College, Western Reserve University:

William F. Conway has been promoted from assistant professor to associate professor of accounting.

William C. Henry has been promoted from assistant professor to associate professor of accounting and has recently been awarded the CPA certificate by the State of Ohio.

Western Reserve University has recently established a separate School of Business Administration at Cleveland College.

University of Cincinnati:

Frederick J. Heinritz and Harry W. McLaughlin have been appointed lecturers in accounting and Wayne S. Overmeyer, formerly of

the University of Akron, has been appointed instructor of accounting.

Ohio State University:

DANIEL M. SHONTING, WALTER C. BURNHAM, WILLIAM B. JENCKS, WILFORD J. FLEIG, and JAMES R. MCCOY have been promoted from assistant professors to associate professors of accounting.

R. CARSON COX and FELIX R. KONKLE have been promoted from instructors to assistant professors of accounting.

NORTON M. BEDFORD, THEODORE P. HERRICK, JR., HARRY MAERKER and EDWARD W. PLODZIK have been appointed instructors of accounting.

SAMUEL R. HEPWORTH, formerly of Washburn Municipal University, has been appointed assistant professor of accounting.

PENNSYLVANIA

University of Pittsburgh:

C. L. VAN SICKLE's *Cost Accounting* is being reprinted, with some revisions, by Harper & Brothers.

Temple University:

STERLING K. ATKINSON presented a paper on the subject of "Sharpening the Tools of Cost Control: Distribution Costs" at the 28th Annual International Cost Conference.

Wharton School of Finance and Commerce, University of Pennsylvania:

THOMAS A. BUDD is scheduled to present a paper on the subject of "The Selection and Training of Industrial Accountants" at meetings of the Binghamton (N. Y.) and Erie and Scranton (Pa.) chapters of the National Association of Cost Accountants. He is also publishing a volume entitled *Financial and Business Statements* through the Alexander Hamilton Institute.

CARL T. DEVINE has resigned to join the accounting faculty of the University of Southern California.

ROBERT B. MITCHELL has been promoted to the rank of associate professor of accounting.

JAMES S. MCALLISTER, WILLIARD E. STONE and RICHARD S. WOODS have been appointed instructors of accounting.

RHODE ISLAND

Rhode Island State College:

WINFIELD S. BRIGGS has been promoted from associate professor to professor of accounting and appointed Head of the Department of Accounting and Business Law.

TEXAS

Texas Christian University:

GARNETT S. DAVIS has been promoted from instructor to assistant professor of accounting and has recently been awarded the degree of Bachelor of Law by Southern Methodist University.

ROBERT H. GREGORY has been appointed Acting Dean in the absence of Dean Sowell. He also presented a paper on the subject of "Recent Developments in Financial Statements" at the spring meeting of the Accounting and Business Administration Section of the Southwestern Social Science Association.

ELLIS M. SOWELL has been given a leave of absence to accept a Rockefeller post-doctoral scholarship at Harvard Graduate School of Business Administration.

University of Texas:

S. M. WOOLSEY has been appointed assistant professor of accounting.

G. H. NEWLOVE's *Consolidated Statements* and the second edition of *Intermediate Accounting* by Newlove-Smith-White are in process of publication by D. C. Heath and Co.

VIRGINIA

University of Virginia:

A. R. COLEMAN is serving as Chairman of the Committee on Education and Ethics, Virginia Society of Public Accountants, and is a member of the editorial board for the projected quarterly publication, *The Virginian Accountant*, to be published by the Virginia Society of Public Accountants.

FRANK S. KAULBACK served as a member of the faculty of the University of California, at Berkeley, during the summer session of 1947.

WYOMING

University of Wyoming:

J. HOWARD CRAVEN and EMILE KAUDER have been appointed assistant professors and HERBERT C. WITTGENSTEIN has been appointed instructor of accounting.

PAUL KOHLER and ARTHUR SCHWEITZER have resigned.

BOOK REVIEWS

HERBERT E. MILLER

Accounting Fundamentals (Second Edition). George A. MacFarland and Robert D. Ayars. (New York: The McGraw-Hill Book Company, Inc., 1947. Pp. xv, 759. $4.50.)

The second edition of this well-known text follows closely the original pattern of eleven years ago. The authors, convinced of the wisdom and teachability of the original material, have strengthened a few weak spots, added some summary materials in certain chapters, and have brought sections up-to-date. For example, the original payroll records contained one deduction column while the new illustrations contain several columns which indicate the usual deductions. As a whole, with respect to the text portion, the new edition is little different from the old.

For those not familiar with the text, the introductory chapter deals with accounting and its significance. Next the three financial statements are illustrated and explained. Two chapters deal with accounts—their purpose and use. Journals and posting are the topics for the next two chapters. A chapter devoted to the trial balance indicates some useful tests to be used when errors have been made. A brief discussion of capital and revenue expenditures is followed by introductory material on adjusting and closing the books. The use of the work sheet completes the material on the bookkeeping cycle. This section covers the first thirteen chapters.

The authors next step back and delve more deeply into adjusting entries, then discuss business papers and practices. Subsidiary ledgers, columnar journals, and auxiliary records complete the second portion of the text. Two chapters on partnerships are followed by five chapters on corporations, including a chapter on reserves and funds and a chapter on bonds. One chapter is allotted to manufacturing accounts and one to the voucher system. The text is concluded with material on the analysis and interpretation of financial statements.

The problem section of the book has been strengthened considerably. In striking contrast to the text, all the problem material is new. More problems are offered and, in this reviewer's opinion, the problems are better and more thought-provoking. Some of the situations presented seem a little complex for beginning students, but this certainly is more advantageous (as well as more interesting for the student) than merely presenting innumerable transactiosn to be journalized by rote.

The text is well-written and makes for easy reading. Controversial points mentioned are discussed briefly, then the author's choice (with reasons) is presented and the subject is closed. Certainly, in a beginning text, this is a valid procedure.

W. B. JENCKS

Ohio State University

Some Specialized Phases of Accounting Practice. Myron M. Strain and Floyd P. Karg. (San Francisco: The Pacioli Press, 1947. Pp. 163. $5.00.)

Students of accounting and practitioners of accounting at times are desirous of obtaining information as to accounting peculiarities of various industrial fields. In many cases, the search for this material is a fruitless one, and even when it is not, one finds dead, dry bones hardly calculated to stir up any interest. This book helps to fill in gaps in our literature, for it deals with accounting problems in three fields, namely, the construction industry, extractive industries, and stock brokers. One starts reading the book with enthusiasm, for the first section (on contractors accounts) is primarily concerned with principles and modifications of general accounting conventions desirable because of peculiarities of the construction industry. As one continues through the book, enthusiasm lags and finally turns to boredom, as accounting seems to descend to the intellectual level of bricklaying.

The section on contractors accounts devotes considerable space to the problem of determining when income should be recognized. The author (Myron Strain) comes out wholeheartedly for the percentage of completion method. He points out the income tax advantages of this method, but fails to point out that use of the completed contract method allows deferring payment of income taxes to later years—a not inconsiderable advantage to a contractor with limited capital. His stress of rising tax rates certainly does not ring true in 1947, when tax men are emphasizing the advantages of pushing income into the future. He minimizes the importance of income measuring methods as far as determination of management policies and the amount of dividends is concerned. It is refreshing to find an accountant who does not believe that financial accounting is the complete answer to all business problems. As to the reliability of this method of measuring income, he cites the opinion of engineers with whom he discussed the problem. For above the ground projects, he reports, uncertainty can be reduced to the typical industrial level. Perhaps this is true, but it would be desirable to have a statistical study as to just how reliable an engineering estimate of percentage of completion is before reaching a final conclusion. The section ends with a refreshingly agnostic view of the value of allocating indirect expenses to the various jobs.

The second section of the book discusses accounting problems connected with mining, petroleum production, and lumbering. Valuation of properties, determination of cost of developing properties, depreciation and depletion methods and dividend policy are all discussed briefly but clearly. The author, however, does not seem to be on quite as firm a ground as when he is discussing contractors accounts, for he confines himself to state-

ments of alternatives with very little discussion as to their merits. He reports, for instance, the shift from market value to cost in valuing crude oil, without any comment as to the relative merits of the two methods.

The last section, on brokerage accounts, is by far the weakest of the three. It contains a detailed description of the accounting records of stock brokers and of their regulation by the SEC and the securities exchanges. There is no reason to suppose that a student's interest will be aroused or his analytical powers challenged by this material.

The book concludes with 35 problems covering the text material. Those on the extractive industries appear to be the best of the group.

CARL L. NELSON

University of Nebraska

Embezzlement and Internal Control. Albert E. Keller. (Washington, D. C.: Warner-Arms Publishing Company, 1946. Pp. 239. $3.00.)

This little book, as indicated by its title, deals only with one aspect of internal control, i.e., the safeguarding of assets from embezzlement. It is described on the jacket as "a cautionary for the businessman." Any business man who devotes an evening to this book will probably have a sleepless night. The twenty-seven chapters are chock-full of anecdotes to remind him of "insidious losses through embezzlement and other irregularities."

As indicated above, the contents of this book consist largely of numerous illustrations of actual cases of fraud and embezzlement. The author states that, "Many of these cases could have been prevented, or at least detected soon after their inception, through effective control procedures plus proper and frequent supervision" (p. 26). No doubt it is Mr. Keller's aim through his repetitive use of cases to emphasize to the businessman the importance of a sound accounting system. Certainly the proper use and understanding of principles of internal check are a necessity in the prevention and detection of fraud. Unfortunately, however, Mr. Keller has devoted too much space to his anecdotes and not enough to "effective control procedures."

The chapters with one exception are short, the pages small and the type large. An introductory chapter entitled "Internal Control" serves to point out what is meant by the term. In addition it contains a suggestion of minimum data to be gathered in the installation of internal control methods. This chapter is followed by ones which cover such specific items as "Petty Cash," "Cash Sales," "Postage," "Customers Accounts Receivable," "Payrolls," etc. Each chapter attempts to point out the desirability of internal control methods through a series of somewhat disconnected cases dealing with the topic suggested by the chapter head. In a few instances it is not quite clear what lesson the illustrative material is intended to teach. For example, thirty pages of a thirty-four page chapter headed "Surety Bonds" were devoted to a direct quotation from a report entitled "1001 Embezzlers" published by The United States Fidelity & Guaranty Company, Baltimore, Md. This report is replete with statistics dealing with the geographical distribution of the embezzlements, age distribution and length of service of the embezzlers, etc. To this reviewer the inclusion of this lengthy quotation had the same morbid effect as the inclusion of a statistical report of a life insurance company's death claims in a book on preventive medicine—possibly even more so since so many previous chapters had included obituaries.

If the author intended that his little book should serve as a warning to businessmen not trained in accounting that the absence of such training may result in losses he has demonstrated his intent. If, on the other hand, he has intended to provide them with the technical knowledge necessary to protect their assets from embezzlement he has only demonstrated.

RUFUS WIXON

University of Buffalo

Financial Administration of Municipal Utilities. Irving Tenner. (Chicago: Public Administration Service, 1947. Pp. xi, 152. $3.75.)

The superintendent, commissioner, or councilman concerned with a municipally owned utility will find Tenner's book a useful guide to many phases of utility operations. While the principles and techniques discussed have their application in all municipal utilities, large and small, personnel of the latter will use the book to greater benefit. Larger utilities usually have specialists in various fields in their employ or available in other city departments. Such matters as centralized purchasing, debt administration, and budgetary procedures will be assigned to persons whose primary interest and training are in those subjects. The small utility, however, is often a one-man show with all operations, financial, production, and distribution, being administered by one individual. Knowledge and training along financial lines often take second place to engineering and technical training in production and distribution when such a manager is employed. To these managers, this book will be a practical handbook.

In the preface the author states, "Important factors in financial administration include: financial organization, financial policies, rate structures, budgeting, debt administration, handling customer accounts, proper custody and control over cash, the proper purchasing, storaging, and issuing of materials and supplies, accounting for salaries and wages, proper management of fixed assets, general and cost accounting principles and procedures, and good financial reporting." These subjects are discussed in twelve well organized chapters, each of which is divided into various subordinate subjects. There is a detailed table of contents. Tenner's sentences are short and easily read. The book is written as a guide to best financial practices and discussion of theory behind such practices has been minimized or eliminated. For example, in the chapter devoted to the management of fixed assets, Tenner states, "Fixed assets are those that have a unit value of about $5 or more and are expected to last longer than one year." Many accountants would not have the temerity to use such a definition, but as a working guide for utility operators, it will serve its purpose. Illustrations of a number of

forms are included in the text and the various financial statements for an electric utility and a water department are reproduced.

PAUL F. ICERMAN

Icerman, Johnson & Hoffman
Ann Arbor

Foremen's Unions: A New Development in Industrial Relations. Carl J. Cabe. (Urbana, Ill.: University of Illinois, Bureau of Economic and Business Research, 1947. Pp. 74.)

The role and status of foremen's unions is currently one of the most dynamic and controversial subjects in the field of industrial relations. This bulletin is chiefly concerned with the history and development of foremen's unions through March, 1947, with an appraisal of certain of these developments. It is not a discussion of techniques for dealing with foremen's unions, and in fact many of the materials are dated, or at least have limited applicability, in view of the Labor-Management Relations Act of 1947. Under the LMRA employers are not required to bargain with "supervisors," and also "supervisory" unions apparently would not be subject to many of the regulations affecting rank and file unions. But it is important to recognize that the specific administrative rules of the LMRA will not be known until there have been many court rulings on the various sections of the Act. A similar situation with respect to foremen's unions prevailed under the National Labor Relations Act, and Cabe's study and evaluation of the previous court cases might provide insight into the reasoning used by the courts in the past, with possible implications for future court interpretations. Cabe's study will be of principal value, however, to students and professional workers in the field of industrial relations; it provides a convenient and concise summary of developments in foremen's unionization prior to LMRA.

The first Chapter is concerned with changes in the status of foremen, and traces some of the factors responsible for their present alleged "neither management nor worker" status. Chapter Two deals with some of the causes of foremen's unrest with emphasis upon narrowed wage differentials between foremen and the workers they supervise. The historical development of foremen's organizations is treated in Chapter Three. This chapter, and the following one on legal status, are, in the reviewer's opinion, the best in the report.

Cabe points out that prior to World War II foremen customarily belonged to unions in the printing, building and metal trades, and the maritime and railroad industries, and that at least 29 unions include both foremen and production workers. He then traces the development of the Foreman's Association of America, supervisors in the mining industry, and briefly mentions the Mechanic's Educational Society of America. The discussion of the legal status of foremen's unions is especially noteworthy and is both succinct and comprehensive. The final Chapter discusses the economic and social significance of foremen's unions and includes an all too brief discussion of the problems that such unionization could raise in general union administration. The bulletin has an excellent bibliography.

Cabe's work was originally prepared as a master's thesis. The University of Illinois should be commended for bringing this excellent report to a wider audience in bulletin form, and it would be desirable if other institutions would follow this practice.

HERBERT G. HENEMAN, JR.

University of Minnesota

Price-Quantity Interactions in Business Cycles. Frederick C. Mills. (New York: National Bureau of Economic Research, Inc., 1946. Pp. xii, 140. $1.50.)

This volume is the second in the National Bureau's Twenty-fifth Anniversary Series. It deals with the interrelated changes of commodity prices and physical quantities under the impact of cyclical fluctuations. The book is in the form of a partial report on a general study of revenue and outlay changes and the working of the price mechanism in business cycles. It introduces methods of defining joint cyclical behavior of prices and quantities, as well as methods of measuring elasticity of quantities and flexibility of prices.

Much can be said for the methodology used in the study. The book is readable and understandable, which too often is not true of books written in the field of statistical analysis. The few mathematical formulae used are of an elementary nature and this alone makes the work more useable as a reference in courses in business and economic statistics. It is difficult to judge the contribution of one in a series of publications when the series is not intact. However, one cannot doubt that this work is able to stand on its own feet as an individual study.

Professor Mills' study takes cognizance of the fact that the changes affecting quantity and price are due to diverse influences. Nevertheless, the work is based upon the assumption that there is reason to expect some orderliness in the behavior of the factors concerned when studied in the framework of reference cycles, and that there is justification for a systematic attempt to define these changes.

The study is divided into three major sections: Interactions of Unit Prices and Quantities in Business Cycles; Patterns of Buyers' Outlay and Sellers' Revenues in Business Cycles: Aggregative; Patterns of Buyers' Outlays and Sellers' Revenues in Business Cycles: Commodity Groups. Sixty-four commodities are studied, and these are divided into sixteen commodity groups. The period covered by the most extensive of the commodity records used in this study is from 1858 to 1939. The business cycle is broken into nine "Reference Cycle Stages" beginning with the "initial" trough. It can readily be seen that this is a most ambitious undertaking.

The data which are used are not always fully comparable in regard to price, although an attempt is made to make them so by having all relate to wholesale markets. These markets, of course, vary widely in character and the work recognizes the data as being approximations only. The care with which the study was made and the recognition of its weaknesses is deserving of high

commendation. The explanatory footnotes, constructed to clarify the procedure and direct the reader, are excellent; but many of them could have been dispensed with and the information included in the body of the study without the reader losing the thought of the writer.

As an aid to business or government much can be said for the book. It is of the "over-all picture" type, and makes no attempt to classify commodity groups by competitive status of the producing industry. It does not suggest that such is either desirable or possible. But the student of economic and business research will find much material in this work which will stimulate the desire for further research.

The book presents a twelve page summary of the findings. These are laid out in a clear-cut fashion that makes the work extremely useful as a reference for student's of business cycles. As is frequently the case, the summary should be read first, for it serves as an inspiration to the reader to study the detailed analysis.

This review is intended as an evaluation, and it would be unfortunate if the reader were to believe that the study is easily analyzed, for such is not the case. The scope of the work alone makes it difficult to follow the method. Certain definitions of flexibility and elasticity are used, with which the reader may be unfamiliar. Nevertheless, it is possible to read this book and to understand the methodological techniques, and that in itself is a recommendation of any book in the field of statistical analysis. Professor Mills and his coworkers are to be congratulated for presenting a timely and readable piece of work.

C. Frank Smith

Indiana University

The A B C of Accounting. Stanley Edwin Howard. (Princeton: Princeton University Press. 1946. Pp. xv, 320. $3.50.)

A glance at the title of this text might imply that it is just another text in the elementary principles of accounting. The text is unusual in two respects. First, it is written to serve the needs of a definite group; the student who is studying economics as a part of the curriculum of the liberal arts college, as distinguished from the vocational or professional type. Second, emphasis is placed upon the fundamental concepts and relationships rather than upon rules of accounting procedure. The text is written to cover one semester of work.

The mechanics of the accounting process are presented in accordance with the balance sheet approach. Only a sufficient description of the mechanics is given to enable the student to understand the "why" of accounting principles. Traditional definitions of current assets and current liabilities are stated. The reader is surprised to find that Adam Smith's differentiation between the types of assets is not quoted. This would appear to be particularly appropriate in a text of this type. Hypothetical and actual accounting statements are presented early in the text. The inclusion of statement forms used by the Federal Trade Commission (retail merchants and manufacturers), Federal Reserve Board, Interstate Commerce Commission (for steam railroads), and the Bureau of Internal Revenue should prove to be a helpful instructional device. The computation of information for periodic adjustments is covered in an adequate manner particularly in view of the fact that the reader is led to understand that the accountant compiles the adjusting information. It has been the reviewer's experience that students too often gain the impression from texts that the figures for the periodic adjusting entries reach the accountant in some miraculous manner.

Depreciation, depletion, and amortization are discussed under the title of wasting assets. One may gain the impression in reading this section that the author may be thinking entirely of a physical wasting, rather than valuation wasting with respect to depreciable and amortizable assets. However, the concept of valuation wasting is covered in the discussion.

In discussing the purpose of charging depreciation, the author probably places too much stress upon the concept of the maintenance of proprietary capital. Perhaps, a greater stress upon the cost allocation concept as the purpose for charging depreciation would lend a better balance. The author recommends that losses and gains arising from the disposal of fixed assets (in the case of corporations) might be carried to surplus. Even though this may be his personal preference, it would have been desirable to have presented a fuller discussion of the method for treating such items in the statement of revenue and expenses.

Reserves for self-insurance and bad debts are discussed from the viewpoint of risk bearing and providing for the attendant possible losses in connection with the operation of business. This approach is unusual. It is interesting to note that the author feels that losses should be recognized when incurred, and that it is not the function of the accountant to equalize expenses. Often accountants attempt to devise dubious techniques for the equalization of expenses.

Reserves and funds are thoroughly discussed. The presentation is such that the student should acquire an excellent understanding of the function of and the means used for establishing each.

The simple elements of cost accounting are discussed from the point of view of a small manufacturing establishment. Several pages are devoted to the topic of noncontractual "costs." In a text of this type, it appears that an entire chapter should have been devoted to this topic.

A chapter of over twenty pages is devoted to a discussion of interest and discount on short term notes. This lengthy treatment appears unnecessary.

The chapter on bond interest is devoted to the computation of bond values and the treatment of discount and premiums. One gains the impression that interest rates are determined solely by the risk involved. However, later it is indicated that interest rates may emerge from the demand and supply situation in the investment market. A better correlation of the factors determining interest rates and bond prices would be helpful.

The chapters dealing with the disposition of proprietary income and the interpretation of accounting records are presented in an understandable manner.

The text contains an adequate number of illustra-

tions (called exhibits)—a total of forty-six. The twenty-two problem assignments are unusual in two respects. First, the majority of the problems are stated in the narrative, rather than in the tabular form. This arrangement has the advantage of requiring more thought on the part of the student when he solves the problems. Second, each problem is provided with four sets of figures, any one of which may be assigned for use in solving the problem. This arrangement is particularly adaptable when instructors return problems to the students after they have been submitted and graded. By rotating the sets of figures used, the copying of old problems may be minimized.

It is the reviewer's opinion that Professor Howard has presented the elementary principles of accounting in a very satisfactory manner, particularly from the point of view for which this text has been written. Furthermore, one may safely say that a student who has completed this text will achieve as adequate an understanding of the fundamental concepts and relationships in elementary accounting as is usually achieved in the traditional two semester text. The author is able to emphasize the "why" of elementary accounting, because he has been able to keep the "how" to a minimum.

Bruce Futhey

Michigan State College

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